Petri Mäntysaari

The Law of Corporate Finance: General Principles and EU Law

Volume III: Funding, Exit, Takeovers

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1 Introduction

1.1 Cash Flow, Risk, Agency, Information, Investments

The first volume dealt with the management of: cash flow (and the exchange of goods and services); risk; agency relationships; and information. The firm manages these aspects by legal tools and practices in the context of all commercial transactions.

The second volume discussed investments. As voluntary contracts belong to the most important legal tools available to the firm, the second volume provided an introduction to the general legal aspects of generic investment contracts and payment obligations.

This volume discusses funding transactions, exit, and a particular category of decisions raising existential questions (business acquisitions). Transactions which can be regarded as funding transactions from the perspective of a firm raising the funding can be regarded as investment transactions from the perspective of an investor that provides the funding. Although the perspective chosen in this volume is that of a firm raising funding, this volume will simultaneously provide information about the legal aspects of many investment transactions.

1.2 Funding, Exit, Acquisitions

Funding transactions are obviously an important way to manage cash flow. All investments will have to be funded in some way or another. The firm's funding mix will also influence risk in many ways.

Funding. The most important way to raise funding is through retained profits and by using existing assets more efficiently. The firm can also borrow money from a bank, or issue debt, equity, or mezzanine securities to a small group of investors.

Securities can also be issued to the public. In this case, the management of information will play a central role. For example, the marketing of securities to the public is constrained by the mandatory provisions of securities markets laws, and there can be ongoing disclosure and other obligations for issuers.

Exit. The firm must manage exit-related questions in two contexts. First, the firm's own investors will want an exit at some point of time. There is a very wide range of exit forms depending on the investment. For example, an investor can sell his claims to another investor, the company can make payments to an investor

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who wants out, the company can merge with another company, or there can be an IPO. Exit can influence the firm's cash flow and create risks. Second, the firm will act as an investor itself. In this case, it must manage its own exit.

Business acquisitions (existential decisions). Business acquisitions belong to the largest investments that the firm will make. The acquisition must also be funded in some way or another. For example, the buyer might issue securities to the public, a small number of investors, or the sellers. Alternatively, it might borrow money from a bank.

For the target firm, business acquisitions can raise existential questions. For example, the target's board may have to decide whether the target should remain independent or accept a takeover proposal. In addition to business acquisitions, existential questions are normally raised by corporate insolvency (which will fall outside the scope of this book).

Business acquisitions are legally complicated, and they involve the use of most legal instruments discussed in Volumes I–II. Typically, there is a contract between the buyer and the seller. The management of information plays a major role in this context.

1.3 Financial Crisis

The financial market crisis that began in mid-2007 affected the funding of firms on a very large scale. There was a "Minsky moment". The legal aspects of funding and exit transactions nevertheless remain unchanged. The same legal tools and practices that were available before the crisis will be available even after the crisis.

On the other hand, the financial crisis increased risk-awareness. One can therefore assume that risks will be managed more carefully immediately after the crisis (before firms again become less risk averse and start reacting to the fear of negative things occurring rather than risk as such).

Before the crisis, there was a trend towards higher and higher leverage. During the crisis, it became more difficult for non-financial firms to raise debt funding. As a result, it became vital for firms to have enough equity on the balance sheet and to ensure liquidity by hoarding cash. After the crisis, firms may again have better access to debt funding.

One of the things that could change the funding mix of firms after the financial crisis is the choice of principal. The trend towards higher leverage was partly caused by the choice of shareholders as the most important principal in corporate governance. However, firms whose managers choose to further the long-term interests of the firm rather than the short-term interests of its shareholders are more likely to survive in the long term.

2 Funding: Introduction

2.1 General Remarks

The purpose of Chapters 2–7 is to discuss the legal aspects of the most important forms of funding from the perspective of a non-financial firm. There are various forms of external funding ranging from traditional debt and shareholders' capital to mezzanine capital. The firm can also release capital and retain earnings. The purpose of this chapter is to provide an overview.

2.2 Separation of Investment and Funding Decisions?

There can be different views in financial economics and corporate finance law (as well as business practice) about whether investment and funding decisions are separate decisions.

Financial economics. In financial economics, funding and investment decisions are separate decisions. When the firm considers the acquisition of an asset, it should estimate the cash flows that are expected to arise from the ownership of the asset. These should then be discounted at a rate that reflects the risk associated with those cash flows. The asset should be acquired if the net present value (NPV) is positive. How the acquisition should be financed is another matter.[1]

According to the *separation theorem*, investment and financing decisions can be separated if there is an opportunity to borrow and lend money (the Fisher-Hirshleifer separation theorem first identified by Irving Fisher). Investment decisions and financing decisions should thus be made independently of one another.

The separation theorem has three important implications: First, the firm should invest in projects that make it wealthier. Second, the personal investment preferences of individual "owners" are irrelevant in making corporate investment decisions, because individual "owners" can maximise their personal preferences for themselves Third, the financing method does not affect the "owners'" wealth.

The separation theorem is complemented by the *unanimity proposition* according to which firms need not worry about making decisions which reconcile conflicting shareholder interests, because all shareholders are thought to share the same interests and should therefore support the same decisions.

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[1] See, for example, McLaney E, Business Finance. Sixth edition. Pearson Education, Harlow (2003) p 237.

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However, the unanimity proposition does not describe corporate reality very well. For example, because of private benefits of control, company decisions affect the interests of the controlling shareholder in ways other than through the decision's impact on the value of the company. In company groups, the business interests of the parent or the group as a whole normally affect decision-making in companies belonging to the group.[2]

In Volume I, it was argued that shareholders cannot be regarded as the firm's "owners" in the first place and that they do not share the same interests.

Corporate finance law. In corporate finance law, questions of funding and investment are, for four reasons, very often connected.

First, the providers of funding also provide ancillary services (section 2.3 below). Who holds the claim in general matters.[3] Some investments are not possible without the ancillary services of certain finance providers.

Second, the firm cannot acquire any asset without funding. (a) Very often the acquisition and funding are part of the same contractual framework. Such cases range from simple purchases of supplies or equipment (section 3.4.2) and simple financial leasing transactions (section 3.3.3) to asset-backed or structured finance (section 3.4.4), and generally to large transactions in which the availability of funding is a typical condition precedent to closing (Chapter 20). (b) Even where the acquisition and funding are not part of the same contract framework, the availability of external funding can influence the amount that the firm can invest or the price that it can pay. For example, the availability of debt funding can depend on whether potential lenders believe that the cash flows from the asset enable those debts to be repaid or whether the asset can be used as collateral. The structuring of the acquisition can therefore be influenced by the interests of the lenders and other investors and depend on the structuring of the funding transaction.

The connection between investment and funding decisions can be illustrated by the takeovers of Chrysler, an American car manufacturer, and ABN Amro, a Dutch bank.

Chrysler. In 2007, the suddenly tightening market for corporate debt and the high volatility of stock markets meant that many leveraged buyouts either collapsed or had to be renegotiated because the banks that had agreed to lend money began to press for better terms. Cerberus Capital Management, which agreed to acquire the Chrysler Group from DaimlerChrysler, had to re-negotiate its deal just before closing. Cerberus had to provide more equity, and the seller had to lend some of the money to Cerberus.

ABN Amro. In the ABN Amro case, there were two competing bids in 2007. Barclays Bank, an English bank, noticed that a consortium led by Royal Bank of Scotland, a Scottish Bank, had submitted a higher bid for ABN Amro. Barclays Bank then brought on board two strategic investors, China Development Bank, a state-owned bank, and Temasek, Singapore's government investment vehicle. They agreed to subscribe for shares in Barclays Bank. This enabled Barclays Bank to revise its offer.

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[2] See also Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) p 1665.

[3] Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 75.

Third, when choosing the funding mix, part of the firm's risk management is to take into account the assets being financed. Firms that are safe, produce steady cash flows, and have easily redeployable assets that they can pledge as collateral can afford high debt-to-equity ratios. In contrast, risky firms, firms with little current cash flows, and firms with intangible assets, tend to have low leverage. Companies whose value consists largely of intangible growth options have significantly lower leverage ratios than companies whose value is represented primarily by tangible assets.[4]

The fate of Northern Rock, a British mortgage bank, is an example of the relationship between the assets being financed and funding. Northern Rock relied largely on short-term borrowing from the capital market to fund its mortgage lending practices and to offer more attractive mortgage rates than its conservative competitors. When the interbank market was temporarily disrupted, Northern Rock faced a liquidity crisis and anxious customers queued up wanting to take their money out. In 2007, Northern Rock became the first British lender in 30 years to be granted a bailout by the Bank of England. The problems of Northern Rock were largely caused by its business model.

Fourth, a funding transaction can be someone else's investment transaction, and the legal framework of the transaction must address the concerns of both parties.

2.3 Forms of Funding, Funding Mix, Ancillary Services

All investments must be funded in one way or another. In addition to other investments, the firm will need to hoard reserves as part of its overall liquidity and risk management in order to mitigate the risk of liquidity shortages.[5]

Funding mix, ancillary services. From the firm's perspective, the typical forms of funding are: retained earnings; capital released by the firm; debt; shareholders' capital (equity); and mezzanine. There can be even other forms of funding ranging from the investments of asset investors (sections 3.3.1 and 9.2) to state aids (see Volume II).

The firm will thus choose a *funding mix* by weighing up the financial, commercial, and legal advantages and disadvantages of different sources of funding. The funding mix depends on: the availability and cost of capital; corporate risk management and the management of agency relationships between the firm as principal and investors as agents (Volume I); the ancillary services provided by the investors; and other things.

Providers of external funding can provide *ancillary services* such as signalling services, monitoring services, management services, access to markets, access to technology, and so forth. For example, shareholders' company law rights partly

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[4] Tirole J, *op cit*, pp 99–100. See also Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) p 63, citing Myers SC, Capital Structure, J Econ Persp 15 (2001) pp 81–102 at pp 82–84.

[5] Tirole J, *op cit*, pp 199–200. See also Desperately seeking a cash cure, The Economist, November 2008.

facilitate the provision of ancillary services (Volume I). The provision of ancillary services is sometimes based on particular contract terms (joint-venture agreements, venture capital, project finance, shareholders' agreements, and so forth). The scope of ancillary services depends on the form of funding, the investor, the firm's needs, and other things.

For example, shareholders have particular functions in a limited-liability company (Volume I). In a large listed company with dispersed share ownership and mainly short-term shareholders, few shareholders have actually provided funding by subscribing for new shares. However, many shareholders have a pricing and monitoring role. In an industrial firm, block-ownership can facilitate an industrial partnership. In a venture capital transaction, an equity investment is often combined with the provision of management services.

The Second Company Law Directive provides that the subscribed capital may be formed only of assets capable of economic assessment and that an undertaking to perform work or supply services may not form part of these assets.[6]

The *overall cost* of funding is not limited to the direct costs of capital. The overall cost of funding depends also on the value and cost of ancillary services. The firm's choices can reflect the *relative weight* of different parties as providers of funding and ancillary services.

For example, a listed company's share buyback programme can decrease the value of its publicly-traded bonds and lower its credit rating. Its choices can therefore reflect the relative weight of bondholders and shareholders as providers of funding and ancillary services. Before the financial crisis that began in 2007, share buyback programmes were used as a takeover defence designed to increase the share price and the cost of a takeover. During the crisis, it became important to hoard liquidity. Share buyback programmes were not necessary, because the hostile bidders would have been unable to finance their bids.[7]

Furthermore, *corporate risk management* plays a very important role, because the firm's funding mix influences its risk profile (Volume I).

This has also been recognised by the Bank for International Settlements: "A bank's ability to withstand uncertain market conditions is bolstered by maintaining a strong capital position that accounts for potential changes in the bank's strategy and volatility in market conditions over time. Banks should focus on effective and efficient capital planning, as well as long-term capital maintenance."[8]

Different forms of funding have different *legal and commercial characteristics*. There are differences relating to both funding aspects and the typical ancillary services. (a) For example, borrowing is flexible, but the firm must repay its debts and

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[6] Article 7 of Directive 77/91/EEC (Second Company Law Directive). See also Articles 10, 10a, and 10b on consideration other than in cash.

[7] Knop C, Koch B, Köhn R, Frühauf M, Psotta M, Preuß S, Das Ende der Aktienrückkauf-Programme, FAZ, 26 March 2009 p 15.

[8] BIS, Basel Committee on Banking Supervision, Proposed enhancements to the Basel II framework. Consultative Document (January 2009), Supplemental Pillar 2 Guidance, paragraph 10.

pay interest.[9] (b) In contrast, the repayment of shareholders' capital is subject to restrictions, but shareholders typically demand a higher return because of the equity nature of their claims. Furthermore, shareholders may increase the cost of shareholders' capital by using their legal and de facto powers. For example, they may be able to force the company to distribute more funds to shareholders in the short term. In addition, the issuing of shares can change the share ownership structure of the company and vest shareholders' rights in the subscribers of the new shares. (c) The cost of debt and shareholders' capital is normally influenced by tax laws.

As a result, some forms of funding are more popular than others. *Tirole* has summarised the result of several studies as follows: "In all [studied] countries, internal financing (retained earnings) constitutes the dominant source of finance. Bank loans usually provide the bulk of external financing, well ahead of new equity issues, which account for a small fraction of new financing in all major OECD countries."[10]

Corporate finance has not succeeded in explaining the capital structure of firms. In two papers, published in 1958 and 1963, Franco Modigliani and Merton Miller argued that a firm's financial structure made no difference to its total value and was therefore irrelevant. According to them, managers and owners should therefore devote themselves to maximising the value of their firms and waste no time thinking about gearing and dividends.

However, the Modigliani-Miller theorem does not hold in a world with agency costs, asymmetric information, and other market imperfections. The choice of the financial structure of the firm can affect its value. The irrelevance theory is true only in circumstances so rare that they are the exception rather than the rule.[11]

There is no universal theory of the debt-equity choice. There are several conditional theories. The three major competing theories of capital structure are the trade-off theory, the pecking-order theory, and the free cash flow theory.[12]

Shareholders' capital. In perfect capital markets, shareholders' capital is the most expensive form of funding for the firm. Shareholders should require a higher return because of legal constraints on repayment and on distributions to shareholders.

On the other hand, the firm needs some amount of shareholders' capital as equity. Equity increases the survival chances of the firm in hard times, and shareholders' capital makes it easier for the firm to raise debt capital, because it decreases risk for debt investors. The rights of shareholders are part of the price that the firm has to pay for investor lock-up.[13]

Too much shareholders' capital can nevertheless be bad for the firm for corporate governance reasons (see Volume I). For example, the lack of debt removes an

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9 For the optimal amount of debt, see Smith CW, Warner JB, On Financial Contracting. An Analysis of Bond Covenants, J Fin Econ 7 (1979) pp 117–161 at p 154.

10 Tirole J, *op cit*, p 96.

11 Generally, see Tirole J, *op cit*.

12 Myers SC, Capital Structure, J Econ Persp 15 (2001) p 81.

13 See Hansmann H, Kraakman R, Squire R, Law and the Rise of the Firm, Harv L R 119 (2006) p 1343.

incentive to be effective. Furthermore, a listed company can attract hostile bidders if it is not lean. If the firm is on the market for control and the firm wants to remain independent and survive in the long term, the firm must signal several important points to potential buyers: that its capital is already being employed in an efficient way; that the amount of assets that can be distributed to shareholders is limited; that the buyer would not be able to finance a hostile bid by loading the firm with new debt; and that a takeover would bring a low rate of return. A company that is on the market for control therefore prefers to keep the amount of shareholders' capital and the amount of funds that can be distributed to owners low.

The real cost of shareholders' capital can be higher or lower compared with abstract financial theory. Capital markets are not far advanced in all countries. Even in highly developed countries, the cost of shareholders' capital depends on the firm.

For example, shareholders' capital may sometimes cost less because of certain ancillary services provided by block-holders or shareholders acting as business partners. The cost of shareholders' capital can also be reduced by the private non-pecuniary benefits of controlling shareholders.

Protection against hostile takeovers is a common ancillary service provided by controlling shareholders. Even in countries with highly developed capital markets, a company is not yet on the market for control if it is controlled, directly or indirectly, by an owner who has no intention to sell and who holds a block of shares large enough to make it impossible for anyone else to obtain control. The company is typically not on the market for control if it is controlled by a long-term shareholder or shareholders, such as a family, a foundation, or a state.

On the other hand, the cost of shareholders' capital can be increased when influential shareholders have a very short investment perspective and only try to maximise their own short-term profits regardless of the interests of the firm. This is one of the main differences between, say, large listed companies and family-owned firms.

Even information management can play a role. Investors might be uncertain about the motive behind the firm's financing decision. For example, the issuing of new shares could be interpreted by the market as a sign of overvaluation, and firms do tend to issue shares during good times when share prices are high.[14] Alternatively, it could be interpreted as a sign of a profitable investment opportunity. In order to convince investors that the latter is true and make them forget what they should know about the rational behaviour of issuers, the issuer can mask the issuance as one made necessary by a profitable investment decision such as a takeover and communicate the investment decision clearly to the equity market.[15]

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[14] See, for example, Tirole J, *op cit*, p 244

[15] See Schlingemann FP, Financing decisions and bidder gains, J Corp Fin 10 (2004) pp 683–701, citing Myers SC, Majluf NS, J Fin Econ 1984 pp 187–221 (overvaluation) and Cooney JW Jr, Kalay A, J Fin Econ 33 (1993) pp 149–172 (profitable investment opportunity).

Debt. Increasing debt and gearing can increase return on shareholders' capital, provided that the firm makes a profit. Increasing debt is often used as a corporate governance tool, because regular and compulsory payments to lenders force the firm to be efficient in order to survive. The market for corporate control, the activities of private-equity firms, and corporate takeovers in general can increase the indebtedness of companies.

On the other hand, a very high gearing increases the risk of business failure and can make it more difficult for the firm to survive in the long term. A very high gearing can also increase the cost of debt and reduce its availability. If the firm has too much debt, the firm must pay more for debt capital. Too much debt can do many things: increase the risk for banks, suppliers and other providers of debt capital; decrease the credit rating of the firm; decrease the availability of debt; and increase its cost.

The risks inherent in high leverage can be illustrated by German takeover targets and the fate of Carlyle Capital Corporation in 2008. In *Germany*, companies taken over by private-equity firms in 2004–2008 were typically highly leveraged following the takeover. In 2008–2009, many such companies filed for bankruptcy.[16] The *Carlyle Group* is a high-profile private-equity firm. It operates as a private partnership and is owned by a group of individuals. Carlyle Capital Corporation (CCC) was a publicly-listed company on Euronext Amsterdam N.V. Although part of the Carlyle family, The Carlyle Group and CCC were separate legal entities. A bond fund of CCC had used gearing of 32 times to buy AAA-rated paper.[17] As a result of the subprime mortgage crisis, the market value of those assets fell and their liquidity was reduced. At the same time, banks became more risk averse and reluctant to lend money to private-equity firms. CCC had to sell assets to meet margin calls. The Carlyle Group supported CCC by extending a $150 million line of credit. After failing to reach an agreement with its creditors in March 2008, CCC defaulted on $16.6 billion of debt. The Carlyle Group said that it expected CCC to default on the rest as well. CCC's lenders took possession of CCC's remaining assets and sold collateral.

Mezzanine. There is a wide range of mezzanine instruments. The purpose of mezzanine instruments is to combine the benefits of shareholders' capital and debt while avoiding some of their drawbacks.

Equity and debt components can be combined in various ways. Whereas some mezzanine instruments are regarded as equity in the balance sheet of the company (equity mezzanine), other mezzanine instruments are regarded as debt (debt mezzanine). There are also mezzanine instruments that consist of an equity component and a debt component (hybrid mezzanine).

As equity and debt components can be combined in various ways, the firm can benefit from the wide range of investors' risk preferences. The firm can issue a wide range of securities with different levels of seniority, that is, different rights to payment.

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[16] See, for example, Paul H, Am Ende entscheidet die Persönlichkeit des Private-Equity-Managers, FAZ, 19 March 2009 p 16.

[17] See, for example, Fehr B, Ruhkamp S, Die dritte Welle der Finanzkrise, FAZ, 14 March 2008 p 29; If at first you don't succeed, The Economist, March 2008.

For example, securities issued by the firm may belong to different tranches. One tranche will be regarded as more senior and repaid before securities that belong to other tranches can be repaid. Another tranche will be regarded as less senior and repaid only provided that securities belonging to other tranches have been repaid.

Terminology. In corporate finance law, the meaning of the terms "equity", "debt" and "mezzanine" can depend on the context and the perspective.

From a legal perspective, different forms of capital will be treated differently depending on the applicable legal rules. For example, capital that, according to traditional *national* accounting rules, is regarded as "equity" may be regarded as "debt" under *IFRS*. According to the provisions of *company law,* a company can have different forms of capital. Moreover, the *tax* treatment of different forms of capital can vary.

Even the subjective perspective can play a role. A certain "debt" instrument may thus be regarded as an "equity" investment by an *investor* buying an instrument with a better ranking or, if the capital amount of that instrument does not have to be repaid soon, by the *company* issuing the instrument.

In this book, "equity" and "mezzanine" are regarded as techniques rather than distinct categories of funding. "Equity" is understood as the result of the use of the "equity technique" (section 5.1), and "mezzanine" as the result of the use of the "mezzanine technique" (section 6.1). A distinction is made between shareholders' capital and other forms of equity.

The Basel II Accord has its own terminology. For supervisory purposes, capital is defined in two tiers, core capital (Tier 1) and supplementary capital (Tier 2). At least 50% of a bank's capital base must consist of a core element comprised of equity capital and published reserves from post-tax retained earnings (Tier 1) as defined in the Basel II Accord. Elements of supplementary capital will be admitted into Tier 2 limited to 100% of Tier 1.[18] *Tier 1* capital means equity capital and disclosed reserves. Equity capital means "issued and fully paid ordinary shares/common stock and non-cumulative perpetual preferred stock (but excluding cumulative preferred stock)".[19] *Tier 2* capital or supplementary consists of undisclosed reserves, revaluation reserves, general provisions/general loan-loss reserves, hybrid debt capital instruments, and certain subordinated term debt.[20]

Reduction of external funding needs, retentions. Whereas equity, debt and mezzanine capital are regarded as the three main forms of external funding, internal financing constitutes the dominant source of finance.[21] Typical ways to reduce the firm's external funding needs include: retained earnings, reducing the amount of invested capital, as well as chain structures and pyramids.

Most firms retain a substantial portion of the earnings left over after the firm's contractual obligations have been met rather than pay them out in the form of dividends to shareholders or bonuses to employees.

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[18] Paragraph 49(iii) of the Basel II Accord.

[19] Paragraph 49(i) and footnote 13 of the Basel II Accord.

[20] Paragraphs 49(iv), 49(v), 49(vii), 49(xi), and 49(xii) of the Basel II Accord.

[21] See Tirole J, *op cit*, p 96.

In economics, retentions can be defined as the difference between post-tax income and total payments to investors. Total payments to investors include payouts to shareholders (dividends, share repurchases), and payments to creditors (principal and interests) and to other security-holders.[22] From an accounting perspective, the ways to fund investments from operations include, in particular: financing from cash flow;[23] financing by means of amounts written off (depreciation);[24] and financing by means of accruals and provisions.[25]

The firm can reduce the amount of invested capital. Whereas it is difficult to increase profit margins, it is easier for the firm to increase return on invested capital by reducing the amount of invested capital. The firm can reduce the amount of invested capital in many ways. The firm can simply sell assets, but the sale of assets can mean that the firm loses them. The firm cannot do business without core assets and customers. From a legal perspective, the basic ways to reduce the amount of invested capital without losing customers and the availability of core assets include: (a) the reduction of working capital through credit management and cash management; (b) the reduction of capital invested in tangible and intangible assets through leasing and asset finance; and (c) outsourcing in general.

Chain structures and other control-enhancing mechanisms are a further way to reduce other capital needs (Chapter 7). For example, a chain of legal entities where one entity controls another enables the firm to exercise influence over the last entity in the chain with a smaller capital investment, if each entity in the chain has raised funding from external non-controlling investors.

Internal funding can be less expensive than external funding. As lenders typically fear agency costs, a firm that borrows from a bank or from the financial markets will have to pay more compared with a similar firm that finances itself from its own resources ("external finance premium").

Outside lenders fear that the firm will exploit its inside knowledge and the cost of enforcing contracts to repay less than it should. The gap between internal and external financing (the external finance premium) depends on the strength of a borrower's finances and the information available to the lenders. Borrowers in good financial condition generally pay a lower premium.[26]

Structured finance. Structured finance provides an advanced method to release capital and reduce the firm's external funding needs.

Structured finance is a broad concept. There is no consistent definition. According to the Committee on the Global Financial System, structured finance instru-

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[22] *Ibid*, p 95.
[23] In German: Selbstfinanzierung.
[24] In German: Abschreibungsfinanzierung.
[25] In German: Rückstellungsfinanzierung. In the UK, a distinction is made between accruals and provisions. In Germany, both are regarded as Rückstellungen.
[26] Bernanke B, Gertler M, Gilchrist S, The Financial Accelerator and the Flight to Quality, R Econ Stat 78 (1996) pp 1–15; Bernanke B, Gertler M, Gilchrist S, The Financial Accelerator in a Quantitative Business Cycle Framework. In: Taylor JB, Woodford M (eds), Handbook of Macroeconomics, vol. 1, part 3. North-Holland, Amsterdam (1999) pp 1341–1393.

ments can be defined through three key characteristics: (1) pooling of assets (either cash-based or synthetically created); (2) tranching of liabilities that are backed by the asset pool; and (3) de-linking of the credit risk of the collateral asset pool from the credit risk of the originator, usually through use of a finite-lived, standalone special purpose vehicle (SPV).[27]

In short, a typical structured finance transaction involves the pooling of assets that generate a cash flow and the sale by an SPV of debt instruments (bonds or notes) backed by those cash flows. Whether the SPV can repay its debts depends on the cash flow generated by the pooled assets.

Project finance. There is a large variety of particular forms of finance. Project finance is a form of "asset-backed finance". It is provided for a legally and economically self-contained project (a "ring-fenced" project). The project finance itself has two elements: equity capital, provided by investors in the project; and project finance debt, provided by lenders. Project finance debt differs from normal bank loans because the loan will be repaid from the future cash flow of the project.

Takeover finance. The firm may need to raise large sums of money when it acquires a business undertaking. There are many forms of takeover financing. A small-scale buy-out might simply be financed by bank borrowings. There may be an exchange of shares. Mature companies may be able to raise this funding through the stock market. There can be a mixture of debt and equity finance. If the buy-out is very large, the loan may come in the form of a syndicated loan. The assets of the target are an important source of takeover finance; private-equity firms have perfected a technique called refinancing in order to repay short-term takeover loans from the assets of the target.

Trends. Generally, a higher gearing was characteristic of corporate finance in the early 2000's. A higher gearing was caused in particular by three things: (a) corporate takeovers; (b) the existence of a market for corporate control (i.e. the threat of takeovers) as well as share-boosting measures that increased debt on the balance sheet; and (c) the demand for higher-yielding assets (caused by low interest rates and abundant liquidity in the early 2000's).[28]

The credit markets were therefore the motor for three of the big trends of the first decade of the 2000's. First, companies raised more and more capital through privately-issued loan instruments. Second, the lending was increasingly designed from outside the regulated banking industry. Third, much of the debt was raised by leveraged buy-out firms and private equity funds.[29]

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[27] BIS, CGLS, The role of ratings in structured finance: issues and implications, CGFS Publications No. 23 (January 2005).

[28] In the shadows of debt, The Economist, September 2006: "This means new firms, such as hedge funds, have flocked into the loan market, where they can super-size yields by investing in tranches of debt with a higher risk of default, and by borrowing from banks to buy those loans." "Also, the desire of pension-fund managers to buy long-term assets to match their payout commitments has led them into most parts of the credit market. Mutual funds and insurers have flocked in to diversify their portfolios and to spice up their returns."

[29] In the shadows of debt, The Economist, September 2006.

In the capital market, listed companies have for various reasons used share-boosting measures, such as share buybacks. For example, there may be pressure from activist shareholders combined with a more effective market for corporate control caused by private-equity groups. In addition, the use of executive stock option programmes may have increased share buybacks.

The other side of these trends was a reduction in transparency. First, more and more instruments were traded outside regulated markets. Second, leveraged buy-out firms and private equity funds used the money to buy public companies and remove them from the stockmarket. In fact, 2006 marked the first in more than 20 years that European stockmarkets shrunk. Buy-outs, foreign takeovers, and debt-funded share buybacks removed shares from stock markets faster than companies issued them.[30]

2.4 Legal Risks Inherent in Funding Transactions

Funding transactions can be legally complicated. Their legal aspects depend on the form of funding (reduction of capital needs, debt, equity, mezzanine), the enterprise form of the firm, the category of investors, the particular aspects of the transaction, and other circumstances such as the governing law. The legal framework that governs the funding transaction and the related agency relationships between the firm and its various investors depends on the form of the funding.

However, at a general level, funding transactions are influenced by the same general legal aspects as investment transactions. This is understandable, because the firm's own funding transactions can be someone else's investment transactions. In both cases, the firm will regulate four things: cash flow, risk, information, and agency relationships.

Cash flow. In funding transactions, the firm obviously needs to manage the availability and cost of funding. Key funding-related cash flow questions include: access to funding; the mechanism of raising funds; the management of costs and the mechanism of payment of costs; and the repayment of funds. The modalities of the transaction are, to a large extent, determined by its structure. The cost of funding is influenced not only by agreements, but also by tax aspects and the accounting treatment of the transaction.

Risk. To the firm, the legal aspects of risk are basically the same in funding transactions as in investment transactions. For example, there is a risk that costs will increase, if they were not dealt with properly in the contractual framework, or that the contract will be interpreted to the detriment of the firm (see Volume II).

Some legal risks are characteristic of funding transactions. The most important of them relate to the availability and withdrawal of funding (the investor's exit), default, cost, and the power of investors to influence the management of the firm's business.

[30] *Ibid*.

First, there is thus a general risk of not having *access* to sufficient funding. This risk is increased by over-reliance on one source or institution. Over-reliance can be part of the business model of the firm (as in the case of Northern Rock) or caused by its commercial choices (such as over-reliance on one bank) or legal choices. For example, funding contracts between the firm and one source may make it difficult for the firm to raise funding from other sources. Over-reliance is likely to increase other risks inherent in funding.

Second, there is the *exit* risk (such as the acceleration risk in debt funding). For many reasons, the source of funding may disappear and the firm may have to re-pay funds that it already has received. (a) An investor may claim the repayment of funds he has invested and exit the firm according to the normal terms of the in-vestment. (b) On the other hand, exit can also be surprising and happen earlier than expected. Such acceleration may be caused by the materialising of counter-party commercial risk (for counterparty commercial risk, see Volume II). For ex-ample, the firm might prefer long-term investors, but a particular investor might choose to terminate the investment for many reasons, such as: because it may do so under the terms of the investment contract; because of the firm's own default and the investor not wanting to give a waiver; because of the investor's need to in-crease liquidity; because of the investor's own insolvency; or for other reasons. (c) Acceleration may also be caused by the materialising of a general legal risk (Vol-ume II). For example, the funding transaction may turn out to be invalid due to a change of law.

Third, there is the *replacement* risk. After the termination of a funding ar-rangement, it may be difficult for the firm to replace the funding arrangement with a similar arrangement. The lack of funding can, in the worst case, lead to insol-vency of the firm.

There were two sources of pressure on the banks in 2008, concern about solvency and li-quidity. The former was caused by non-performing loans and mark-to-market losses. In ad-dition, it caused problems with the latter, because banks were having trouble raising long-term debt and replacing or refinancing shorter-term debt. Questions about solvency and li-quidity ruined the reputation of the banking sector as a whole, and made the problems worse.

Fourth, there is the *refinancing* risk. If the firm replaces the funding arrangement with a similar arrangement, the firm may have to pay more for its funding. For ex-ample, refinancing costs in a mortgage transaction include not only the new inter-est rate but also transaction costs. Part of the costs may be caused by terms of the existing funding arrangement. The firm may have agreed to pay fees and charges in the event that it wants to terminate the arrangement. The firm may also have agreed to pay a prepayment penalty or to reimburse the investor for the loss that the investor has sustained.

Fifth, there is the risk of *repossession*. (a) Repossession risk may depend on the firm's actions. The risk of repossession is relevant, for example, in asset finance where the firm has granted security interests or ownership-based functional equivalents to security in its assets. (b) Repossession risk may depend on the firm's contract party. For example, there may be a higher repossession risk where:

the asset is leased from a financial intermediary that acts as a specialised redeployer of specific assets with specialist knowledge of their alternative uses; and it is easy for the intermediary to terminate the contract.[31] Typical examples of such redeployers include aircraft-leasing firms and real estate firms. (c) In addition, repossession risk depends on the transaction. There is a high repossession risk at the expiry of leasing contracts, unless the lessee has an option to purchase the asset from the lessee.[32]

Sixth, there are various other risks related to *collateral*. (a) In addition to the repossession risk, there is a market risk. If the value of the collateral declines, the firm may be forced to give the collateral-taker more collateral or pay. (b) There is a similar risk when the collateral arrangement is about to expire. In that case, the collateral-taker often makes an "extend or pay" claim. Extend or pay claims are usual, for example, in demand guarantees. (c) The collateral-giver may itself be exposed to counterparty risk. Depending on the legal circumstances, the collateral may not be easily recoverable if the collateral-taker defaults.

Seventh, there are various risks related to *covenants*. Covenants are typically used as credit enhancements. They act as contractual constraints that limit the actions of the firm. Too restrictive covenants can prevent the firm from taking the best business decisions, increase the firm's costs, increase the risk of default by the firm; and make it more difficult to raise new funding from other sources.

Eight, several legal risks are connected with *transferability*. The transfer of claims can signal a deterioration in their quality. In addition, the transfer may increase agency costs or counterparty commercial risk, because the transferor may have been a better agent or counterparty than the transferee will ever be. For example, a share block might be bought by a competitor, or a long-term debt might be bought by a hostile financial institution for the purpose of terminating it on grounds of alleged default.

Ninth, there is the risk of *conflicting contracts*. It can be legally complicated to raise equity, debt, or mezzanine finance, and to release capital. Without proper drafting, the legal framework of one transaction can contain aspects that breach the terms of another transaction and are regarded as a default.

Information. In funding transactions, the firm typically undertakes disclosure obligations in order to reduce investors' perceived risk.

All contract terms and other terms of funding can signal something to investors. A contract term signals the firm's willingness and ability to comply with it.

There also specific disclosure obligations based on contract. Breach of representations or information covenants can amount to default and increase costs, or trigger the acceleration of payments or the termination of the contract.

Disclosure obligations can also be based on mandatory laws. For example, funding transactions are influenced by their accounting and tax treatment, which, in many cases, determine the structure of the transaction. In capital markets, issuers must comply with mandatory disclosure rules.

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[31] Generally, see Habib MA, Johnsen DB, The Financing and Redeployment of Specific Assets, J Fin 54 (1999) pp 693–720.

[32] *Ibid*, p 703.

This means that it is important to the firm to manage outgoing information (for the distinction between incoming and outgoing information, see Volume I).

Agency relationships. It is characteristic of funding decisions that they are influenced by agency considerations that are different from those that influence investment decisions.

First, the management of agency relationships belongs to the core questions of corporate governance (see Volume I). From the perspective of the firm, the choice of a funding mix also means the choice of a mix of agents providing a mix of ancillary services like monitoring the firm's management and ensuring the long-term survival of the firm.

Second, one of the core duties of the firm's top management, as its agents, is to decide on the allocation of value and risk between different stakeholders. Many of them (shareholders, creditors, and asset investors) are providers of funding.

Third, as regards specific funding transactions, the other party is an agent and a source of counterparty commercial risk. The management of counterparty commercial risk is particularly important for four main reasons: an investor might decide to withdraw its investment, after which the funds will not be available any more; an investor might transfer its investment to another investor contrary to the interests of the firm; an investor might have too much say in the management of the firm; and an investor might exercise its powers to the detriment of the firm.

Agency problems of funding. Mainstream corporate governance scholarship has focused on the problem of expropriation of outside investors by company insiders. The existence of conflicting interests and the agent's risk aversion are some of the usual causes of agency problems in this context. For example, creditors can typically incur agency costs because of: claim dilution; asset withdrawal; asset substitution; and underinvestment (see Volume II).[33]

There are agency problems even when the firm is regarded as the principal and providers of funding (and ancillary services) are regarded as its agents. The firm can incur agency costs because of:

- claim dilution (investing in other projects can mean that the investor will not be able continue funding the firm or increase the funding);
- the withdrawal of funding (it can be difficult or costly to replace the funding arrangement with a new one);
- investor substitution (the transferability of claims can reduce the investor's incentives to act in the interests of the firm, and the quality of transferees as investors and providers of ancillary services can vary);

[33] The three foundational studies are: Jensen MJ, Meckling WH, Theory of the firm: Managerial behavior, agency costs and ownership structure, J Fin Econ 3 (1976) pp 305–360; Smith CW, Warner JB, On financial contracting: An analysis of bond covenants, J Fin Econ 7 (1979) pp 117–161; and Myers SC, Determinants of corporate borrowing, J Fin Econ 5 (1977) pp 147–175. See also Bratton WW, Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process, EBOLR 7 (2006) pp 39–87.

- insufficient effort (the investor may invest too little in the provision of ancillary services to the firm); and
- unwanted use of discretion (the investor may use discretion in an unreasonable way, be too controlling, or act contrary to the interests of the firm otherwise).

Management of risk. There are various ways to mitigate such risks. In any case, the firm should apply four general policies.

The first is *diversification*. The firm should diversify its funding sources. (a) The entire funding of the firm should not be from one source or institution only, and the funding contracts of the firm should never prevent the firm from turning to other sources for necessary funding. The consent of existing shareholders, lenders or other investors should not be a condition. (b) In addition, the firm should not rely on just one form of funding. For example, Northern Rock (see above) had sought to diversify its funding sources around the world. However, it relied largely on short-term borrowing from the capital market. When the interbank market dried up globally, Northern Rock faced a liquidity crisis.

The second is *centralisation*. There should be a central authority for raising finance and for the legal review of funding contracts. Without centralisation, the risk of conflicting contracts and covenant default could be too high. The firm should ensure that borrowing is prohibited without the prior permission of the central authority and only on terms and conditions approved by the central authority.

The third is managing the specific risk inherent in *each transaction*. The firm can manage its own risk exposure. For example, the firm can try to reduce the risk of default by diluting the covenants that it must comply with.

The fourth is managing *investors' perceived risk* for the purpose of reducing the cost of funding. For example, the firm tends to use many kinds of credit enhancements (see Volume II). The equity technique and the mezzanine technique are amongst the most important legal techniques used by firms in the context of corporate finance.

2.5 Particular Remarks on the Subprime Mortgage Crisis

The 2007 subprime mortgage crisis can help to highlight some risks related to funding. The subprime mortgage crisis triggered a global financial crisis followed by a global recession.

Subprime lending. Subprime lending (also called B-paper, near-prime, or second chance lending) was the practice of making loans to borrowers who did not qualify for the best market interest rates because of their poor credit history. Subprime lending was risky for both lenders and borrowers.

There was plenty of demand. Low interest rates, increasing property values and a low perception of risk made subprime mortgages and adjustable rate mortgages popular in the US.

There was also plenty of supply. One of the reasons was that the Basel Accord was designed to deal with the risk that big borrowers might default. It required

banks to set aside capital. Banks looked for ways around the minimum capital rules by shifting assets off their balance-sheets. They did this by securitising their loan portfolios, by using structured investment vehicles, and by transferring the risk of borrowers defaulting to issuers of CDSs.[34]

Mortgage securitisation played a big role. In the past, a local bank lent money to people that it knew. The loans were kept in the bank's books until they were repaid. Mortgage securitisation enabled banks to sell mortgages to SPVs that issued securities to pay for the mortgages. Banks earned fees for originating loans without the burden of holding them on their balance-sheets (which would have restricted their ability to lend to others). What made this easier was the easy availability of AAA ratings for senior tranches.

Banks and financial institutions invested in the US subprime mortgage market through "conduits" or "structured investment vehicles" (SIV). Conduits issued short-term paper to buy collateralised debt products with a maturity of several years. This exposed them to the mismatch between long-term assets and short-term liabilities.

Bursting of the bubble. In 2006, rising interest rates and the bursting of the US housing bubble began to cause an increasing number of defaults, seizures of collateral, and foreclosures. Several major US subprime lenders filed for bankruptcy.

As mortgage-related products were downgraded, investors lost confidence and refused to buy any type of mortgage-backed security. The illiquidity even spread beyond housing.

Liquidity crisis. Banks now became more risk averse. Generally, high leverage and banks' reliance on short-term borrowing from the capital market combined with falling asset prices led to a liquidity crisis.

Assets had to be sold, but there were few buyers because of falling prices and the lack of funding. This caused asset prices to fall even more.

Solvency crisis. A liquidity crisis led to a solvency crisis, as it was unclear whether banks, hedge funds, private-equity funds and other investors had enough assets left to repay their debts.[35]

Recession. Losses wiped out banks' equity. Because of minimum capital requirements, banks had to find fresh capital or scale down their lending activities. Only states and sovereign wealth funds had large amounts of capital to invest, and it became more difficult for non-financial firms and consumers to borrow money from banks. This led to a global recession.

The case of IKB. The way the risks materialised can be illustrated by the fate of IKB Deutsche Industriebank, a specialist industrial lender. IKB is a relatively small bank lending money to the German Mittelstand.

IKB had participated in the US subprime mortgage market through a "conduit" or "structured investment vehicle" (SIV). The conduit, Rhineland Funding, was a special-purpose vehicle which borrowed in the short-term, commercial-paper market to make acquisitions of highly rated paper in US asset-backed securities.

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[34] A short history of modern finance. Link by link, The Economist, October 2008.

[35] See, for example, Fehr B, Ruhkamp S, Die dritte Welle der Finanzkrise, FAZ, 14 March 2008 p 29.

IKB did not formally own the conduit (because IKB wanted to keep the conduit off its balance sheet) but controlled it and provided some of its funding (in order to profit from speculation in the US market).

Now, IKB had invested in US asset-backed securities through its conduit. The value of the assets that backed the securities decreased because of problems with subprime loans. This made it more difficult for Rhineland Funding to borrow in the commercial-paper market, and caused a liquidity crisis in the conduit.

IKB tried to rescue its conduit. As IKB did not any more have access to short-term commercial paper through its conduit, it had to lend more money to the conduit. Simultaneously, it had to turn to the interbank market to address its own short-term cash needs. However, fears for banks' high risk exposures in general, and IKB's own exposures in particular, made it difficult for IKB to borrow money from the interbank market. Other banks feared that IKB might collapse. This caused a liquidity crisis in the bank.

IKB had to be rescued by the regulators and other German banks. The estimated total cost of rescuing this small bank was €10.7 billion, of which KfW (a state-owned bank) and the Federal State paid €9.2 billion (for state aids, see Volume II). In August 2008, Loan Star, a Texas bank, acquired IKB for an estimated €115 million.

2.6 Funding Transactions and Community Law

Gathering information about the regulation of funding transactions in the EU is a time-consuming exercise. Funding transactions are governed or influenced by many areas of law. Legal rules exist at different levels (international, Community, national, market place, internal). Unlike the US, the EU does not have a unified and coherent system of securities law. The relevant market practice can depend on the location of the market in a certain Member State. The only thing common to such legal rules and practices is that they form the legal framework within which the firm operates.

3 Reduction of External Funding Needs

3.1 Introduction

The firm can influence its external funding needs in many ways. The firm can retain earnings. The firm can manage its investment in tangible and intangible assets as well as the amount of its working capital. The firm can use its existing liquidity better (cash management). In addition, financial institutions which are subject to minimum capital requirements based on their risk exposure (under a legal framework implementing the Basel II framework or otherwise) can influence their capital needs by managing their risk exposure.

The less external funding the firm needs, the less the firm will have to pay for its funding (for the "external finance premium", see section 2.3). In addition, reducing the firm's external funding needs can: lead to a reduction of the firm's indebtedness; reduce the risk of the firm defaulting on its credit terms; improve the firm's credit rating; and reduce the cost of debt. The Basel II framework which applies to banks and financial institutions in the EU creates a further mechanism that makes the reduction of capital needs influence the cost of borrowing.

If the reduction of external funding needs both saves money and is good for the firm, why do firms not do more of it? There can be many reasons for this. First, the firm may already be lean. Second, the firm may lack information and financial know-how. Third, even if the firm were informed of the theoretical savings, the transaction costs might be high. Some of the transactions that help to release capital are very complicated and expensive. Fourth, capital may be too cheap to be worth saving: interest rates may be low; the company may have a controlling shareholder who requires a very low level of profit distributions; the equity capital of a state-owned company may be subsidised; and so forth.

The management of capital invested in tangible and intangible assets may typically have the largest impact on the firm's funding needs and will therefore be discussed first. Such questions will be followed by the management of working capital, cash management, and the special case of financial institutions.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
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3.2 Retained Earnings

Internal financing constitutes the dominant source of finance.[1] In a limited-liability company, the main rule is that this form of financing is at the discretion of the board.

Whether the firm makes a profit depends on its business choices. The law cannot say how much profit a company should make, or how it should make a profit. At the strategic level, deciding on the allocation of value between the company and its stakeholders and between stakeholders inter se belongs to the board's core functions.

In addition, the board can block the distribution of assets to shareholders in many ways. For example, distributions to shareholders are constrained by the provisions of the Second Company Law Directive (see section 10.2.2), and decisions on the making of distributions in the form of dividends or share repurchases require the consent of the board. – There can be exceptions to the main rule of board discretion depending on the governing law and the company form. For example, the general meeting or a qualified minority can demand the distribution of minimum profits; such a rule may be regarded as necessary in order to protect non-controlling minority shareholders against controlling shareholders, or to protect shareholders in general. The general meeting may also have a limited right to give binding instructions to the board.

Companies operating as Real Estate Investment Trusts (REITS) must distribute the bulk of their income to investors in regular dividends in return for tax breaks at the company level.

3.3 Management of Capital Invested in Assets

3.3.1 Introduction

Generally, the firm can reduce funding needs by choosing a less capital-intensive business model. The firm can reduce its other external funding needs by using traditional financial transactions such as leasing (section 3.3.3) or sale and lease-back transactions (section 3.3.4). The firm can also release capital for a certain period of time through sale and repurchase arrangements (repos), or reduce its other external funding needs by borrowing the securities it needs for a certain period of time. Private-equity firms have perfected a method called refinancing in order to reduce external funding needs and to return capital after a successful takeover (section 10.5).

Just sell. Of course, the firm can simply release capital by selling existing assets. The firm can sell physical assets, existing claims, and rights to future income

[1] Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 96.

streams. Factoring and securitisation can be said to belong to this category, and the assets of the target are an important source of takeover finance.

Sell but continue to use. Many of the transactions that reduce external funding needs or release capital mean that the firm sells assets but continues to use them. Sale and lease-back transactions obviously belong to this category. On the other hand, one could say that even factoring and the securitisation of customer receivables enable the firm to release capital but keep its most important asset, that is, the customer relationships which are the source of its business.

Use instead of buy. Some transactions mean that the firm just uses assets without buying them. Leasing transactions are not the only transactions that enable the firm to do so.

Asset investors. Leasing companies belong to a larger category of investors that will hereafter be referred to as "asset investors".

Asset investors can range from owners of premises in which the firm operates to owners of intellectual property rights that the firm may use under a licence agreement, and from providers of operating leasing services to network partners whose distribution channels or resources the firm uses in its operations. In a broad sense, even employees and managers can be regarded as asset investors.

Although there are many types of asset investors, it is characteristic of them to enable the firm to use certain assets without the firm having to buy them. The particular legal aspects of asset investing depend on the contract type (see section 9.2).

The wide range of asset investors can be illustrated by the case of Carlos Tevez and Javier Mascherano. Before 2007, these famous Argentine football players still had no experience in the English Premier League. In the absence of verifiable information about how they would adapt to the game as it was played in England, no football club was prepared to pay a high transfer fee for their contracts. However, the economic rights to Carlos Tevez and Javier Mascherano were owned by a company called MSI acting as an "asset investor". MSI permitted West Ham United FC to take Tevez and Mascherano on loan. After the players had shown that they could adapt to the English game, MSI was able to negotiate better deals with other football clubs. In 2007, Mascherano went to Liverpool FC and Tevez to Manchester United FC.

Chain structures. The use of a chain of legal entities can reduce the top entity's own funding needs, where one entity always controls another and each entity in the chain has raised funding from external non-controlling investors (for chain structures and other control-enhancing mechanisms, see Chapter 7).

3.3.2 Excursion: IFRS and Derecognition

Whether the use of leasing or sale and lease-back will release capital as intended can depend on the applicable accounting rules and what is known as derecognition.

Financial transactions will help the firm to release capital provided that the financial assets that they relate to are removed from the firm's balance sheet (derec-

ognised).[2] An entity that derecognises a financial asset in its entirety includes the difference between the carrying amount and the consideration received (including any cumulative gain or loss that had been recognised directly in equity) in the income statement.[3]

Assessing whether or not a financial asset should be derecognised is normally straight-forward. Financial assets are removed from the balance sheet through sale, payment, renegotiation, or default of the counter-party.[4] For example, when a manufacturer receives a payment from a customer for the delivery of spare parts, the manufacturer no longer has any rights to further cash flows from the receivable. It should remove the receivable from the balance sheet (in other words, derecognise it).[5]

However, where an entity sells a portfolio of trade receivables or mortgages for funding reasons, it is less obvious whether those financial assets should be derecognised. Examples of such arrangements include debt factoring and securitisation schemes.

The Application Guidance in IAS 39 summarises the criteria for derecognition in IAS 39. The derecognition process consists of five main steps:[6] (1) the consolidation of all subsidiaries (an entity first consolidates all subsidiaries and special purpose entities and then applies the derecognition principles to the resulting group);[7] (2) identification of the assets or parts of assets that will be tested for derecognition (an entire asset, a fully proportionate share of the cash flows from an asset, specifically identified cash flows from an asset, or a fully proportionate share of specifically identified cash flows from an asset);[8] (3) assessment of whether the firm's contractual rights to the cash flows from the financial asset (or part of the asset) have expired or are forfeited (derecognition only provided that they have expired or are forfeited, the asset has no value and should be derecognised if there are no longer cash flows accruing to the entity);[9] (4) assessment of whether the firm has transferred its contractual rights to another party (an entity that has sold a financial asset has transferred its rights to receive the cash flows from the asset, but additional requirements have to be fulfilled to conclude that so-called pass-through arrangements meet the criteria for a transfer);[10] and (5) the application of derecognition tests. An entity derecognises an asset if two things apply: (a) the entity transfers substantially all the risks and rewards of ownership of the asset;[11] and (b) the entity loses control of the asset.

[2] IAS 39R.9.
[3] IAS 39R.34.
[4] IAS 39R.9.
[5] IAS 39R.17(a).
[6] For a detailed explanation of each step, see IAS 39R.AG36.
[7] IAS 39R.15.
[8] IAS 39R.16. The tests may be applied to any of the following: an entire asset (for example, an unconditional sale of a financial asset); a fully proportionate share of the cash flows from an asset (for example, a sale of 10 percent of all principal and interest cash flows); specifically identified cash flows from an asset (for example, a sale of an interest-only strip of a loan); or a fully proportionate share of specifically identified cash flows from an asset (for example, a sale of 10% of an interest-only strip of a loan).
[9] IAS 39R.17(a).
[10] IAS 39R.17(b); IAS39R.18(a). For "pass-through arrangements", see IAS 39R.18(b).
[11] IAS 39R.20(a).

Transfer of risks and rewards of ownership. It is not possible to derecognise an asset unless the entity transfers substantially all the risks and rewards of ownership of the asset (see above).

There are many examples of such transfers: an unconditional sale of a financial asset; a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and a sale of a financial asset together with a put or call option that is deeply out of the money (an option so far out of the money it is highly unlikely to go into the money before expiry).

On the other hand, the entity must continue to recognise the asset if it retains substantially all the risks and rewards of ownership of the asset. Derecognition requires the transferor's exposure to the risks and rewards of ownership to change substantially.[12]

There are many examples of when an entity has retained substantially all the risks and rewards of ownership and must continue to recognise the asset: a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return; a securities lending agreement; a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity; a sale of a financial asset together with a deep in-the-money put or call option (that is an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

Loss of control. The asset is derecognised if the entity has lost control of it. The entity continues to recognise the asset to the extent of its continuing involvement if it has retained control.[13] Control is based on the transferee's practical ability to sell the asset.[14] The transferee has this ability if it unilaterally can sell the asset in its entirety to an unrelated third party without needing to impose further restrictions on the transfer.

3.3.3 Leasing

Introduction

The lease of an asset is a particular type of hire contract. One party, the lessor, owns an asset and permits another party, the lessee, to use it in exchange for payment of rent.

Importance. Leasing and hire purchase are important sources of funding.[15] In 2005, leasing of equipment and hire purchase accounted for more than 17% of gross fixed capital formation in Europe.

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[12] IAS 39R.20 (b).

[13] IAS 39R.30.

[14] IAS 39R.20(c); AS39R.23.

[15] See, for example, Drury C, Braund S, The Leasing Decision: A Comparison of Theory and Practice, Accounting and Business Research 20 (1990) pp 179–191.

Germany is the largest leasing market in Europe, followed by the UK and Italy. It has been estimated that leased assets account for approximately 20% of corporate capital investment in the UK and Germany. In 2005, leasing accounted for almost a quarter of all investments in equipment (movable capital goods) in Germany.[16]

Forms of leasing. Leasing typically allows the lessee to use assets without any down payment obligation. Leasing can take many forms.

Leasing can be indirect or direct. In *indirect* leasing, a leasing company acts as an intermediary between a customer and a manufacturer. In *direct* leasing, the manufacturer leases the object directly to the lessee.

It is also possible to distinguish between operating leasing and financial leasing. *Operating* leasing is a form of short-term financing. In *financial* leasing, the lessor (typically a financial institution) buys an asset which it leases to an end-user for a substantial proportion of the asset's life. Hire purchase agreements are based on similar legal principles as financial leasing.

The leased assets can consist of movables (cars, machines, equipment) or immovables (land, buildings, business premises). Movable capital goods are inherently more leasable than immovables. The leasing of immovable assets is typically governed by special legal rules and will not be discussed here.

The lease transaction can be complemented with ancillary services such as operation and maintenance (O&M) or installation services.

Benefits. Firms use leasing for many reasons.

- Liquidity. Leasing is a form of financing which leaves credit lines and existing collateral unaffected. In addition, leasing payments can be coordinated with future cash flow (pay as you earn).
- Tax. Leasing can bring tax benefits to some firms. Tax questions are outside the scope of this book.
- Balance sheet. Operating leasing is a form of off-balance-sheet financing.[17]
- Costs. Leasing can, in exceptional cases, be less expensive than debt finance, where the firm, due to an unfavourable credit rating, either is unable to borrow money or is able to raise debt only at a high cost.
- Convenience and flexiblity. There may be operational reasons for leasing. For example, leasing can mitigate the risk of equipment becoming technically obsolete.

Legal aspects in general. The legal aspects of leasing depend on the form of leasing. However, some general remarks can be made.[18]

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[16] Bundesverband Deutscher Leasing-Unternehmen, The Leasing Market 2005; Leaseurope, Leasing Activity in Europe - Key Facts and Figures in 2005; The European Rental Association, The European Equipment Rental Industry 2008 Report.

[17] However, external credit-rating firms take into accounts payment obligations under leasing contracts.

[18] See also DCFR IV.B.

Leasing is always based on a contract between the lessor and the lessee. The lessee may use the asset, but the ownership of the asset will remain with the lessor. This enables the parties to agree on the allocation of risks associated with the residual value of the asset. On the other hand, the parties will have to address the question of to whom the asset will belong after termination of the contract. Will it return to the lessor or will remain with the lessee?

Leasing is a form of functional equivalent to security (see Volume II). The lessor wants to make sure that the lessor can enforce its ownership rights should the lessee become insolvent. General rules on the enforcement of proprietary rights will usually apply, because in Europe, the proprietary rights of a lessor are usually not recognised as a distinct proprietary rights category on their own.[19] For example, legal rules on the classification of a transaction as a "true sale" or an "assignment by way of security" can influence the enforceability of the lessor's proprietary rights against third parties (Volume II).

Additional collateral is usually not necessary as the leased asset belongs to the lessor. The lessor will ensure that the asset may be removed and repossessed in case of repeated payment default as fixed in the contract. Repossession of the asset may be constrained especially in consumer contracts and, depending on the jurisdiction, in contracts that are regarded as hire-purchase contracts (see below).

The parties can have conflicting interests regarding repossession. The lessor will ensure that the asset can be repossessed in the event of serious non-payment or breach of contract. The lessee, on the other hand, should ensure that important assets will not easily be repossessed.

The parties may sometimes agree that the lessor shall offer services during the leasing period to ensure that the asset functions as agreed. For the lessor, this would also be a way to decrease the risk of non-payment. For the lessee, this could be a way to ensure that the asset will fulfil the agreed specifications during the term of the contract.

Generally, the parties can agree on the allocation of risk for the asset, liability for normal wear and tear, the lessee's duty to take reasonable care of the asset, as well as responsibility for maintenance.

Approximation of laws. Member States' leasing laws have not been approximated by Community law. In the EU, consumers are protected by the Consumer Credit Directive in financial leasing transactions.[20] It does not apply to business-to-business transactions. The DCFR recommends some rules on leasing.[21]

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[19] Frick J, Finanzleasinggeschäfte am Beispiel von Aircraft Finance-Transaktionen - Strukturen, Vorteile und Risiken, SZW/RSDA 5/2000 pp 248–249: "Im Gegensatz zu den Vereinigten Staaten ist in Kontinentaleuropa das Recht der Leasinggesellschaft als solches praktisch nirgends als sachenrechtliches Institut anerkannt worden; die dinglichen Wirkungen des Rechts am Leasingobjeckt werden von der Einordnung in das System der Vertragstypen abhängig gemacht (Miete, Abzahlungskauf)."

[20] Directive 2008/48/EC on credit agreements for consumers and repealing Council Directive 87/102/EEC. See, for example, § 491 BGB and § 503 BGB.

[21] DCFR IV.B.

There are nevertheless some international conventions in this area,[22] in particular the 1988 Unidroit Convention on International Financial Leasing (the Ottawa Convention) and the 2001 Convention on International Interests in Mobile Equipment with its associated Aircraft Equipment Protocol (the Cape Town Convention).[23]

The Ottawa Convention and the Cape Town Convention have entered into force for a handful of countries.

The Cape Town Convention and the supporting Protocol (collectively the Convention) were designed to facilitate asset-based financing and leasing of high-value mobile equipment. The Convention provides an international regime covering the financing of interests in aircraft objects, railway rolling stock and space assets through secured loans, sales under reservation of title and leases. The Convention created an international interest which is recognised in all contracting states and an electronic international register for the registration of international interests.

The Cape Town Convention supersedes the 1948 Geneva Convention on the International Recognition of Rights in Aircraft with regards to aircraft and aircraft objects and the 1933 Rome Convention for the Unification of Certain Rules Relating to the Precautionary Attachment of Aircraft with regards to aircraft. The Convention also replaces the 1988 Unidroit Convention on International Financial Leasing with regards to aircraft objects.

Operating Leasing

Operating leasing is a form of short-term financing. There are two parties to an operating lease. The lessor is typically a manufacturer or a rental company, and the lessee uses the asset in its operations. Unlike the sale of goods, operating leases do not transfer ownership to the party that uses the goods. The lessor typically wants to lease the asset to a new customer, and the lessee will not become its new owner after the termination of the lease.

Reasons to use operating leasing. In principle, the firm can use operating leasing for financial reasons. Operating leases are a source of off-balance-sheet financing, and help the firm to show a higher return on assets than would have been possible had the asset been purchased.

As a rule, though, the firm uses operating leasing for operational reasons. (a) The decision whether to buy the asset or to lease it is an operating decision which would be made according to which of the two approaches would be cheaper. (b) Operating leases are often short-term contracts. The firm may prefer to hire an asset that is required only occasionally. (c) Operating leasing also allows equipment to be updated flexibly and transfers the risks associated with the ownership of technologically-advanced assets to the lessor. Usually, the lessor agrees to carry out any necessary maintenance. (d) There may also be other risk aspects. Under

[22] See, for example, Goode R, Contract and Commercial Law: The Logic and Limits of Harmonisation, Electronic Journal of Comparative Law, vol 7.4 (November 2003).

[23] Generally, see Frick J, *op cit*, pp 242–250.

the legal background rules, the lessor as the owner of the asset typically carries the risk for the asset, unless the asset has been lost or damaged through the lessee's negligence.

Legal background rules. Operating leases are governed by legal background rules that apply to rental contracts.[24] Those rules may, for example, provide that a party is free to terminate the contract, unless the parties have agreed otherwise.[25]

If the parties agree that the lessee is free to terminate the contract subject to a defined term and that the lessor is responsible for the maintenance of the leased assets, the lessor bears the commercial risk inherent in investment in the leased assets.

Service providers. Many firms provide operating leasing services. Operating leasing services can be provided by manufacturers as a distribution channel for their products and by rental companies.

Financial Leasing

The finance lease has a fundamentally different purpose to the operating lease. Whereas the operating lease is a short-term hire of goods, the finance lease is a financial tool. Financial leasing is also legally more complicated than operating leasing.

In financial leasing, the lessor is a financial institution that buys an asset which it leases to the user. Unlike operating leasing, a financial leasing transaction involves three parties: the seller (a manufacturer or retailer), the buyer/lessor (a financial instution) and the lessee (the user of the asset).[26]

The lease period is relatively long. The lessor leases the asset to the user for a substantial proportion of the asset's life. Often the minimum period of the lease is approximate to the estimated working life of the equipment. In that case, there will be only one lessee.

The lessee pays rent. The rent is calculated on the basis that will enable the lessor to recoup the capital expenditure of the asset, together with interest. In addition, responsibility for maintenance of the asset rests with the lessee (and not, as in the case of operating leasing, with the lessor).

Financial leases are effectively term loans secured on the asset concerned with capital repayable by instalments. However, while in normal term loans the financial institution may only obtain a security interest in the asset, in financial leases, the financial institution is the owner of the asset.

The potential user normally identifies an asset that it wants to acquire and negotiates terms for its purchase. The potential user then seeks a financial institution to buy it and leases it from the buyer/lessor. Lease payments will need to be suffi-

[24] See, for example, §§ 535–548 BGB.

[25] See §§ 542 and 543 BGB.

[26] Article 1 of the Unidroit Convention on International Financial Leasing contains a definition of financial leasing.

cient to justify the lessor's expenditure, in terms both of capital repayment and of interest.[27] Financial leasing is thus a transaction in which:

- one party (the lessor, a financial institution),
- on the specifications of another party (the lessee, for example an airline carrier),
- enters into an agreement (the sales contract) with a third party (the seller, for example Airbus Industries)
  under which the lessor acquires plant, capital goods or other equipment (for example, new passenger aeroplanes)
  on terms approved by the lessee so far as they concern its interests, and
- enters into an agreement (the leasing agreement) with the lessee,
  granting to the lessee the right to use the equipment (those aeroplanes)
  in return for the payment of rentals calculated so as to take into account in particular the amortisation of the whole or a substantial part of the cost of the equipment.[28]

Reasons to use financial leasing. The firm can use financial leasing for many reasons. In England, they have been summed up as follows: "First, the company may not have the funds to purchase a large asset, or, if it does, it may have a more profitable use for the cash. Second, leasing may provide tax advantages where investment allowances can be secured or where the lessor pays a higher marginal tax rate than the lessee (less tax would be collectable than would have been the case with a purchase). Third, leasing allows equipment to be updated flexibly and transfers the risks associated with technologically-advanced fields to the lessor. Similarly, where a company is ill-positioned to calculate asset depreciation rates it can transfer risks to the lessor. Finally, if leased assets can be kept off the balance sheet (for example, by classification as operating leases) a company can show a higher return on assets in its accounts than would have been possible had the asset been purchased."[29]

Financial leasing enables the lessee to protect its liquidity. The firm can try to match lease payments with income derived from the asset (pay as you earn). At least in some cases, the firm can deduct lease payments or part of them from its taxable income.[30] Financial leasing can be balance sheet neutral for the lessee if the asset is recognised as an asset belonging to the lessor (see section 3.3.2 above). This can help the firm to signal a better return on capital invested.

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[27] See, for example, McLaney E, Business Finance. Sixth edition. Pearson Education, Harlow (2003) pp 235–236.

[28] For a definition, see Article 1 of the Unidroit Convention on International Financial Leasing.

[29] Finch V, Corporate Insolvency Law. Perspectives and Principles. Cam U P, Cambridge (2002) p 112; referring to Samuels JM, Wilkes FM, Brayshaw RE, Management of Company Finance. Thomson Business Press (1995) pp 586–587.

[30] For German tax law, see § 39 Abgabenordnung.

On the other hand, the lessee is not the owner of the asset. The lessee cannot sell the asset if it turns out to be surplus to requirements. The lessee is bound by the agreed leasing period.

Neither is the lessee the buyer of the asset. Disputes regarding the quality of the leased asset can be complicated because of the existence of two contracts (sale and leasing) each with different contract parties.

Long duration. Many legal aspects relate to the long duration of financial leases. The duration of financial leases can be long due to, for example, tax reasons.

One of the key features of financial leasing is its tax treatment.[31] Tax benefits are, for leasing companies, the primary motive behind cross-border financial leasing.[32] Taxation is outside the scope of this book.

The right to terminate the financial lease prematurely would help the firm to manage commercial risk. In aircraft leasing, a carrier may prefer to terminate aircraft leasing contracts in an economic downturn in order to cut costs.[33]

The firm should pay attention to whether, and at what cost, it can terminate the contract prematurely. For example, the termination value of the object often depends on who can be blamed for the termination.

The long duration of financial leases and the importance of the asset value at the time of the expiry of the contract make it necessary for the lessor to ensure that the value of the leased object is maintained during the lease period. The lessor will therefore require a contract term under which the lessee has a duty to use the leased object only in certain ways, maintain and repair it, obtain insurance, pay property taxes, and so forth. Obligations designed to ensure that the value of the leased object is maintained can increase costs for the lessee by, for example, making it more difficult to use and maintain the leased object in an optimal way.[34] The firm (lessee) can mitigate this risk in two main ways. The firm can ensure that it has enough discretion to decide on the use and maintenance of the leased object. In addition, the firm can own core assets, ensure that not all core assets are leased, and ensure that all leased assets are not leased from the same lessor.[35]

Termination clause. The long-term nature of financial leasing is reflected in the termination clause. The parties typically agree that neither party is free to terminate the contract before the expiry of the lease term. As the lessee cannot freely return the leased asset to the lessor, the lessee bears the commercial risk inherent in investment in the leased asset.

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[31] See, for example, §§ 39(1) and § 39(2) of the German Abgabenordnung (AO).

[32] Frick J, *op cit*, p 245: "Die Grundidee liegt also darin, dass mit dem Eigentum an Investitionsgütern verbundene Steuervorteile ausländischen Kapitalgebern zur Verfügung gestellt werden, welche bereit sind, resultierende Steuervorteile (Investment Tax Credits und grosszügige Abschreibungen) mit der inländischen Partei (Eigentümer oder sonstiger Nutzungsberechtigter) zu teilen und tiefe Leasingraten zu bieten."

[33] *Ibid*, p 246.

[34] *Ibid*, p 247.

[35] *Ibid*, p 247.

Ownership of assets after termination. The parties normally agree on what will happen to the leased asset at the expiry of the contract. The lessee is not interested in the ownership of the asset during the leasing period, because the lessee will only pay for the use of the asset. The lessor is typically not interested in the ownership of the assets after the expiry of the leasing period.

It is customary to regulate the question of who will be the owner of the asset after the expiry of the lease term in one of the following four ways:[36] (1) Flexibility. The lessee may have a right to choose: (a) to return the asset to the lessor; (b) to extend the lease term; or (c) to purchase the asset at a price that is determined in the contract. (2) Purchase option. The lessee may have an option to purchase the asset at a price determined in the contract. However, the lessee will exercise that option only if the market price of the asset exceeds the agreed price. (3) Sell option. The lessor may have a right to sell, and the lessee a duty to buy the asset, at the expiry of the lease term. (4) Profit sharing. The lessee may have a duty to return the asset to the lessor, who must sell it. If the price is lower than the agreed residual value, the lessee must pay the difference to the lessor.

In many contracts, the asset is likely to have a low residual value by the end of the lease. This could make it easy for the lessee to acquire the asset. However, where the leasing contract provides that the asset will be acquired by the lessee, the contract may, in some jurisdictions, be regarded as a hire-purchase agreement in which case the rights and obligations of the parties can change (see below). An option to renew the lease would not have the same effect.[37]

Asset quality: lease contract v purchase contract. One of the causes of legal concern is responsibility for the quality of the asset. The problem is that the lessee did not buy the asset from the seller. The lessee selected the seller and determined the asset's specifications, but the asset was bought by the lessor.[38] The lessee's contract party is the lessor rather than the seller. However, the lessor is only interested in financing the transaction and prefers not to be responsible for the quality of the asset in any way.[39] There is therefore tension between the sales contract and the leasing agreement.[40] – The lessee can manage this problem in two main ways.

First, the lessee may agree on the specifications of the object in the lease agreement. The lessor, on the other hand, prefers to exclude its responsibility for the specifications of the object under the lease agreement. This is understandable, because the lessor typically did not negotiate the specifications of the object with the seller. Such exclusion clauses are sometimes regarded as unreasonable and unenforceable. They can be unreasonable, in particular, in preformulated contract

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[36] Werner HS, Eigenkapital-Finanzierung. Bank-Verlag, Köln (2006) p 194.

[37] The Law Commission, Registration of Security Interests: Company Charges and Property other than Land (A Consultation Paper) [2002] EWLC 164(6) (14 June 2002) paragraph 6.15.

[38] See Article 1(2) of the Unidroit Convention on International Financial Leasing.

[39] See nevertheless DCFR IV.B.–3:102 (conformity with the contract at the start of the lease period).

[40] See also DCFR IV.B.–4:104.

terms (see Volume II) and in cases of fraud.[41] Exclusion clauses can also be binding and enforceable. For example, under German law, the lessor's exclusion clause is valid and enforceable, where the potential claims of the buyer (lessor) under the sales contract have been assigned to the lessee.[42]

The second way to manage this problem is by using a Participation Agreement or a similar master agreement that sets out the main characteristics of the transaction as a whole, requires the parties to enter inte various contracts, and is signed by all parties.

Maintenance: rules on rental v rules on financial leasing. Another cause of legal concern is the maintenance of the object. There can be tension between financial leasing and legal background rules. The legal background rules have been drafted with traditional rental of movables in mind, and they can resemble rules on sale of goods.[43] According to those rules, the lessor is responsible for the fitness of the object for the agreed purpose[44] and, indirectly, for the maintenance of the object (the object would not remain fit for the agreed purpose otherwise).[45] The lack of maintenance can mean that the lessee may eventually suspend the making of payments,[46] demand a reduction in payment obligations,[47] claim the reimbursement of damage,[48] or terminate the contract,[49] among other things.

The lessor may therefore prefer to exclude its own maintenance obligations in financial leasing and ensure that the maintenance obligations are undertaken by the lessee. The exclusion of the lessor's maintenance obligations might not be regarded as unreasonable for the lessee where potential claims of the buyer (lessor) under the sales contract have been assigned to the lessee.

Maintenance leasing. In contrast, the lessor will be responsible for the maintenance of the leasing object in maintenance leasing. Maintenance leasing is used by manufacturers. For example, Wärtsilä, a supplier of ship machinery and power plants, provides operating and financial lease structures through a subsidiary. Wärtsilä also provides Operations & Maintenance (O&M) agreements under which it takes performance and operational responsibility for installation, engines and auxiliary systems.

IFRS. Unlike operating leasing, financial leasing is not a source of off-balance-sheet financing. Businesses are required to show both the leased assets and the capital value of the obligation to the owner on the balance sheet.

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[41] § 536d BGB: "Auf eine Vereinbarung, durch die die Rechte des Mieters wegen eines Mangels der Mietsache ausgeschlossen oder beschränkt werden, kann sich der Vermieter nicht berufen, wenn er den Mangel arglistig verschwiegen hat."

[42] BGHZ 68, 118 = BGH, NJW 1977, 848.

[43] See Article 61 of the CISG.

[44] See DCFR IV.B.–3:103 (fitness for purpose, qualities, packaging). See also §§ 326, 536, 536a(1), 536c(1) and 543(2) BGB.

[45] See nevertheless DCFR IV.B.–3:104(2).

[46] See § 326 BGB.

[47] § 536 BGB.

[48] § 536a BGB.

[49] § 543 BGB.

For example, IFRS (IAS 17 Leases) make a fundamental distinction between finance leases and operating leases.

A finance lease is defined as one that transfers to the lessee substantially all the risks and rewards of ownership. It is treated as an "in substance" purchase by the lessee and sale by the lessor. An asset is shown on the lessee's balance sheet at the present value of the minimum lease payments and a corresponding liability is recognised.

An operating lease is any other lease. The underlying asset appears in the balance sheet of the lessor and the lessee simply recognises the rental payments as an expense, with additional footnote disclosure regarding total minimum future lease rental commitments. This commitment must be classified into time horizon categories (less than one year, two to five years and more than five years).

IFRS and the US GAAP share the same basic principles. There are nevertheless some differences in their treatment of leases. Particularly notable is that the "bright line" tests of FAS 13[50] used by the Financial Accounting Standards Board (FASB) in the US are not used under IFRS in Europe. On 19 July 2006, the FASB announced that it would be adding to its agenda a comprehensive reconsideration of the standards on accounting for leases.

Hire-purchase Agreements

A hire-purchase agreement[51] keeps the title to the relevant asset with the hirer/seller until all payments under the agreement have been made in full at the end of the stipulated hire period. Hire-purchase resembles financial leasing in most aspects, with the one exception that the parties know from the beginning that the hiree/buyer will become the owner of the asset after making all payments under the agreement. Title to the goods may then pass automatically (usually after all repayments have been made),[52] or the hirer may have been given the option to purchase the hired goods at a certain point.

Reasons to use hire-purchase. Hire-purchase tends to be an expensive form of finance. The benefit of hire purchase is that equipment supplied by the hire purchase company can be used immediately by the hiree who will only have to make an initial payment rather than pay the full purchase price. The hiree will make a

[50] The US standard FAS 13 introduces "bright lines" into lease classification. It defines lease as one under which any one of the following conditions is met: (i) the present value at the beginning of the lease term of the payments not representing executory costs paid by the lessor equals or exceeds 90% of the fair value of the leased asset; (ii) the lease transfers ownership of the asset to the lessee by the end of the lease term; (iii) the lease contains a bargain purchase price; (iv) the lease is equal to 75% or more of the estimated economic life of the asset. On 19 July 2006, the FASB announced that it is adding to its agenda a comprehensive reconsideration of the standards on accounting for leases.

[51] In German: Mietkauf.

[52] The Law Commission, Registration of Security Interests: Company Charges and Property other than Land (A Consultation Paper) [2002] EWLC 164(6) (14 June 2002) paragraph 6.14.

series of regular payments (including an interest charge) and, after repayment, will become the owner.

The hire-purchase company retains a secure position regarding the insolvency of the hiree, provided that the value of the asset at issue remains higher than the repayment sum outstanding and does so for the duration of the agreement.[53]

Hire-purchase can be governed by special provisions of law.[54] Consumers are protected by the Consumer Credit Directive.[55]

In some jurisdictions, a leasing agreement can be regarded as a hire-purchase agreement where it is clear from the beginning that the hiree/buyer will become the owner of the asset after making all agreed payments. A finance lease that contains provision for the lessee to acquire the equipment may turn turn the transaction into a hire-purchase agreement.[56]

This could influence the rights of the parties. For example, Finnish hire-purchase law provides that the buyer may claim the payment of the cash price but not the payment of interest or fees unless the latter have been disclosed to the buyer in a written agreement that fulfils certain requirements as to form,[57] and re-possession of the object is subject to certain restrictions.[58]

3.3.4 Sale and Lease-back

The purpose of a sale and lease-back transaction is to release capital. Sale and lease-back enables the firm to raise funds through the sale of existing assets to a financial intermediary but it also enables the firm to continue using those assets by virtue of a lease. The firm thus secures funds and only has to pay rental charges which are generally tax deductible. The access to liquidity can outweigh the obligation to pay rental charges.

A wide range of assets can be sold and leased back. Sale and lease-back transactions are often used in real estate finance. HSBC, an international bank, offloaded its Canary Wharf HQ in London to a Spanish property family for £1.1 billion in 2007. After the sale, the buyer received rental income from the HSBC building.[59] The playing rights of many Premier League football players have been owned by the leasing arm of Barclays Bank plc, rather than by the club concerned. Rio Ferdinand, a famous England defender, was leased from Barclays Bank by Leeds United FC when he played for them.[60] Particular forms of sale and

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53 Finch V, Corporate Insolvency Law. Perspectives and Principles. Cam U P, Cambridge (2002) pp 111–112.

54 See also DCFR IV.B.–1:101(3).

55 Directive 2008/48/EC on credit agreements for consumers and repealing Council Directive 87/102/EEC. See, for example, § 491 BGB and § 503 BGB.

56 The Law Commission, Registration of Security Interests, paragraph 6.15.

57 Laki osamaksukaupasta (91/1966) (the Hire Purchase Act of 1966), § 2.

58 § 2 - § 6 of the Hire Purchase Act of 1966.

59 Brodie S, HSBC building hits the heights of £1.1bn, The Telegraph 1 May 2007.

60 McLaney E, Business Finance. Sixth edition. Pearson Education, Harlow (2003) p 238, citing Sunday Telegraph, 14 July 2002.

lease-back are used in cross-border leasing. Cross-border leasing is often tax-driven (see below).

Contracts. A sale and lease-back transaction is basically a transaction between two parties. It consists of two contracts: a contract for the sale of the asset, and a lease contract. The ownership of the asset will be transferred to the buyer. The transfer of ownership protects the buyer against loss. If the transfer of ownership is valid and enforceable against third parties, the lease resembles a loan secured on the asset concerned.[61]

Legal aspects. There are several specific legal constraints on sale and lease-back transactions. The most important of them relate to: (a) what can be sold; (b) what can be leased; (c) whether the transfer of title mitigates the buyer's counterparty risk; (d) the validity and enforceability of essential clauses; and (e) accounting rules.

What can be sold? Some assets cannot freely be sold to the financial intermediary. The sale of some asset classes can require the consent of a third party (for example, due to contractual obligations owed to that third party) or the consent of public authorities (for example, where the ownership or use of those assets requires a government consent). Some rights attaching to certain assets may not be separated from other rights attaching to the same assets (for example, rights attaching to shares may not be separated).

What can be leased back? Some assets cannot be leased back although they can, in principle, be sold and assigned to the new owner. In particular, it might not be possible to separate the ownership and use of some rights attaching to the assets. Generally, this often applies to intangible property. For example, voting rights attaching to shares are exercised by the shareholder that owns the shares now and may not be leased back to a former shareholder that owned the shares in the past. In some cases, the lease-back would not be meaningful due to the fact that important rights attaching to the assets will, by law, be exercised by the owner of those assets.

Transfer of ownership. There is a risk that the transfer of ownership is not valid or not enforceable against third parties. The two most important situations where this might be the case are when the sale is regarded as a mere assignment by way of security rather than a "true sale" and when a third party's prior rights will prevail.

"*True sale" and recharacterisation*. Genuine sale and lease-back transactions can sometimes be difficult to distinguish from a mere assignment by way of security. The parties may sometimes try to evade the operation of mandatory laws that permit only certain forms of security interests that can be enforced against third parties (a numerus clausus of security interests).[62]

However, the parties typically prefer to mitigate the recharacterisation risk. The parties try to ensure that third parties will not be able to argue that the transaction

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[61] *Ibid*, p 242.

[62] For English law, see Re George Inglefield Ltd [1933] Ch.1, where the question was whether a sale and repurchase agreement was an unregistered company charge.

was not a sale at all, but rather a secured financing arrangement that was not properly perfected.

In some jurisdictions, a sale and lease-back transaction is more easily regarded as an assignment by way of security that does not create security rights enforceable against third parties.

For example, in *Switzerland*, the transfer of ownership of movables under a two-party sale and lease-back contract is not enforceable in the insolvency of a Swiss lessee against the lessee's creditors and other third parties, where the leased movables were in the possession of the seller/lessee before the conclusion of the contract.[63] The buyer/lessor is not regarded as the owner of the leased assets, because the parties must not evade legal rules on security interests in movables.[64] In *Germany*, the rules on assignment by way of security are less strict than in Switzerland.[65]

Validity and enforceability of core clauses. For operational reasons, the firm should ensure that the expiry of the lease will not prevent it from using the asset. The sale and lease-back contract usually provides that the seller/lessee has the right or option to purchase the asset at the expiry of the lease period.[66]

That clause is legally relevant even in other respects. (a) If the parties have agreed on the repurchase of the asset in such a way that the buyer/lessor has no market risk, the sale will often be recharacterised as an assignment by way of security rather than as a "true sale". This may make the transfer of proprietary rights to the buyer/lessor unenforceable against third parties. (b) Furthermore, the accounting treatment of the transaction may depend on to what extent market risk has been transferred to the buyer/lessor.

Accounting. The accounting treatment of sale and lease-back depends on the applicable accounting rules. There can be differences between IFRS and national accounting rules.

Sale and lease-back transactions are specifically within the scope of IAS 17 and SIC-27. Leases are classified as finance or operating, based on the extent to which the lessor has transferred or the lessee has obtained "substantially all" risks and rewards incident to the ownership of the leased asset.

The accounting treatment for sale and lease-back transactions depends on the circumstances of the transaction and the lease classification. For example, where the transaction involves the lessor providing finance to the lessee, with the asset as security, it is not appropriate for the seller/lessee to regard an excess of sale proceeds over the carrying amount of the asset as a gain at the time of the transaction.

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[63] BGE 119 II 236; Frick J, Finanzleasinggeschäfte am Beispiel von Aircraft Finance-Transaktionen - Strukturen, Vorteile und Risiken, SZW/RSDA 5/2000 pp 248–249.

[64] Art. 717(1) ZBG and Art. 884(3) ZGB.

[65] § 929 BGB and § 930 BGB.

[66] See Habib MA, Johnsen DB, The Financing and Redeployment of Specific Assets, J Fin 54 (1999) pp 693–720 at p 703. See also Werner HS, Eigenkapital-Finanzierung. Bank-Verlag, Köln (2006) pp 199–200: "In der Regel wird auch eine Rückkaufoption vereinbart, die bei Immobilien grundbuchrechtlich durch eine Auflassungsvormerkung abgesichert werden kann. Durch ein vereinbartes Rückkaufsrecht hält sich das Unternehmen die Möglichkeit offen, das veräußerte Wirtschaftsgut in der Zukunft zurückzuerwerben."

Lease In/Lease Out. There are even other forms of leasing transactions that resemble sale and lease-back. Lease In/Lease Out (LILO) transactions and the related Sale In/Lease Out (SILO) transactions are examples of tax-driven cross-border leasing. They also provide a good example of the high legal risks inherent in tax-driven long-term cross-border transactions.

LILO transactions are transactions in which a financial institution purports to lease property and then purports to immediately sublease it back to the lessor. Such lease arrangements are meaningful for the financial institution for example where they transfer depreciation rights from a tax-exempt entity to a taxpaying entity.[67]

LILO transactions were used by more than 150 German municipalities that sold facilities to US banks between 1996 and 2003.[68] One of those municipalities was the city of Bochum. The city of Bochum handed over its sewerage system to a US investor for 99 years in exchange for a payment of €500 million made by way of a trust. It then leased back the network through a bank in return for a payment of only €480 million, thereby making an instant profit of €20 million. What the US investor got out of the arrangement was the opportunity under US law to set foreign investments against tax. This was because the leased assets were regarded as assets belonging to the US investor under US tax law (although they belonged to the city of Bochum under German law).

Such LILO transactions attracted plenty of negative publicity in Germany because of several legal and commercial risks caused by the long lease period. Because of US tax law, the bank required a covenant according to which the municipality must keep open facilities that have been leased in and leased out and to keep them in good repair. This was likely to increase costs for the municipality. In addition, the municipality might not even need those facilities in the future and would prefer them to be closed down. In many cases, the municipality was responsible for an adverse change risk. This was likely to increase costs even further due to the long lease period. There was also a high change of law risk.

In the US, new cross-border LILO contracts were probihited under the American Jobs Creation Act of 2004. Since 2005, the IRS has regarded even earlier cross-border LILO transactions as abusive, which has ruled out the tax benefits that were the basis of existing transactions.

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[67] See, for example, Yip S, Credit Implications of IRS Scrutiny of LILO/SILO Transactions and Proposed Accounting Guidance for U.S. Banks (February 2006). Available at SSRN. For a description of a typical LILO transaction, see Thomas J (Yale University, School of Management), The tax benefits of Lease-in Lease-out (LILO) transactions. See also Frick J, *op cit*, pp 245–246.

[68] Aus für Sparmodell, FAZ, 20 October 2004.

3.3.5 Repos and Securities Lending

Sale and repurchase arrangements ("repos") and securities lending enable the firm to release capital for a certain period of time (repos) or to use assets for a certain period of time (securities lending). Repos and securities lending have been discussed in Volume II in more detail.

Repos. Sale and repurchase arrangements are a form of title finance. Under a repo contract, a seller raises capital on an asset by selling it to a buyer. The contract requires the seller to repurchase the assets, or equivalent assets, at a future date or possibly upon demand. The seller pays a repurchase price equal to the purchase price and a financing charge. Repos are normally used where the assets are investment securities or investments such as shares, debentures, stock, bonds, bills of exchange and other forms of tradeable debt.[69]

Securities lending. Repos can be distinguished from securities lending. Securities lending is not really "lending" and "borrowing". A securities lending contract consists of two sales contracts. A securities lender undertakes an obligation to transfer (sell) securities to a securities borrower. A securities borrower undertakes an obligation to replace the securities in due course on a specified future date (sell them back). A typical agreement requires the securities borrower to pay a fee to the lender and also provide collateral in the form of cash or other securities. The collateral is transferred through a title transfer arrangement, which enables the collateral to be further used.[70]

3.4 Management of Working Capital

3.4.1 General Remarks

The previous section dealt with how the firm can reduce its investment in tangible and intangible assets. Another important method to release capital is by better management of working capital.

Working capital is an investment. It has no certain return, but it has a real and explicit cost. An increasing working capital means two things: a larger investment, and more funding to be raised in order to finance that investment. The firm can therefore benefit from a reduction in working capital.

Working capital consists of three components: accounts payable, inventories, and accounts receivable. Accounts payable consist of unpaid purchases (obligations and debts due to outside suppliers). Inventories consist of unsold production (raw materials, bought-in components, work in progress and finished goods). Accounts receivable consist of uncollected sales (credit sales owed to the company).

The firm can reduce working capital through management of accounts payable, credit management (management of accounts receivable and the use of factoring),

[69] The Law Commission, Registration of Security Interests, paragraph 6.38.
[70] *Ibid*, paragraph 6.46.

and cash management (cash pooling, netting, the use of a payment factory). Inventories can be reduced, for example, through outsourcing and just-in-time manufacturing.

From a financial perspective, it is common wisdom to collect fast and pay slow. On the other hand, the firm's collection and payment practices signal something to its suppliers and customers and influence their behaviour. For example, a fast payer can obtain better terms and better service, and a customer may regard payment time as an ancillary service.

3.4.2 Management of Accounts Payable

Introduction

In most bilateral transactions, each party has to perform all or part of its obligations at about the same time that the other party has to perform its obligations. For example, in a purchase and sale contract, the buyer will have to pay the seller or make arrangements for it to be paid at more or less the same time that the seller ships the goods to the buyer.[71]

However, there can be an intertemporal value transfer. For example, the difference between the time of purchase and the time of payment can allow a retailer to await payment from its own customers before paying its suppliers.

Accounts payable are one of the usual sources of funding. There are many ways to manage accounts payable. A supplier can permit the firm to pay later. The firm may be able to influence its payment terms or decide to pay late.[72] In addition, some firms buy goods on a consignment basis.

Payment Terms

How the firm can use payment terms to its own benefit and as a way to raise external funding depends on the size of the firm, the nature of the goods or services bought by the firm, and other things.

Main rule. The firm usually does not pay interest on trade debts that it pays on time. In addition, the seller can sometimes grant a discount for prompt payment. The firm may have a legal obligation to pay interest for late payment.

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[71] Bradlow DD, Some lessons about the negotiating dynamics in international debt transactions. In: UNITAR, Problems and Perspectives of Debt Negotiations, DFM Document Series, Document No 9, Geneva (April 2000).

[72] Accounts not receivable, The Economist, September 2008: "A recent survey of large public companies in America conducted by REL, a consultancy, and CFO … shows that … the number of days it takes companies to collect money owed to them … hit an average of 41 in 2007, up from 39.7 in 2006 … When America went into recession in 2001, DSO averaged 38.9. In Europe and Asia average DSOs lie in the high 50s (credit terms tend to be easier than in America) … Chaos in the banking system is also causing managers to think twice about paying promptly … By putting off payments to creditors, treasurers can conserve cash and thus reduce their reliance on nervous bankers."

Size of the firm. Small suppliers are often dependent on a few big customers. In many countries, big customers benefit from their strong bargaining position by paying late. For commercial reasons, it may be difficult for a small supplier to charge penalty interest for late payment from a big customer. Small firms must, in practice, pay earlier because of their weaker bargaining position.

Nature of goods or services. In practice, the payment terms depend on the nature of goods or services bought by the firm. For example, the firm pays in different ways for necessary raw materials and supplies, finished goods that are delivered to the firm, or large machines and equipment that will be installed on site.

Where the goods are finished goods that must be delivered to the buyer, the parties may agree on the date when the price is payable to the seller. As a buyer, the firm can increase its external funding by agreeing on long payment terms. The firm can try to combine long payment terms with no obligation to pay interest on accounts payable. Under legal background rules, no interest is usually payable on the credit before due date, unless the parties have agreed otherwise, but will usually be payable after the due date.[73] The contract may also provide for a reduction of purchase price on early or punctual payment. Such clauses often encourage the firm to pay earlier because a small price reduction for early payment can amount to a high interest rate on a yearly basis. For example, the firm can qualify for a discount perhaps as high as 5% of gross invoice value for prompt payment.

Where large machines and equipment are installed at the firm's site, the starting point is that the seller is unwilling to carry out any work unless the buyer (the firm) pays first, and the firm is unwilling to pay anything unless the firm knows that the agreed specifications will be met. In large transactions, the parties often solve this problem through a combination of two things. First, the parties may agree on a staggered payment schedule that follows the schedule of the seller's main obligations. Second, the parties agree that the seller will provide unconditional bank guarantees payable on first demand (demand guarantees, see Volume II). There are several forms of demand guarantees which the seller may be called upon to provide in favour of the buyer at particular stages of the sales transaction. The most usual forms of demand guarantees are: bid bonds (tender guarantees); performance guarantees (performance bonds, completion bonds); repayment guarantees (advance payment guarantees, interim payment guarantees); retention bonds (payment bonds); and maintenance/warranty guarantees.

Community law. Because of their weak bargaining power, late payment is a problem especially for small and medium-sized businesses.[74] Community institutions have therefore adopted legislation to combat late payment in commercial transactions. The Directive on combating late payment in commercial transactions (Late Payment Directive) provides for interest in case of late payment,[75] clarifies

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[73] See CISG Article 78: "If a party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest on it, without prejudice to any claim for damages recoverable under article 74."

[74] Recitals 7–9 of Directive 2000/35/EC (Late Payment Directive).

[75] Article 3 of Directive 2000/35/EC (Late Payment Directive).

the law on retention of title clauses,[76] and forces Member States to ensure that there is a fast recovery procedure for unchallenged claims.[77] The creditor is also entitled to reasonable compensation for recovery costs without prejudice to national provisions according to which a national judge can award to the creditor any additional damage caused by the debtor's late payment.[78]

The Directive both requires legal rules on the obligation to pay interest after due date[79] and prohibits certain ways to abuse the freedom of contract to the detriment of the creditor.[80] An agreement on the date for payment or on the consequences of late payment which is not in line with the statutory default provisions either is not enforceable or gives rise to a claim for damages; this applies where the agreement is grossly unfair to the creditor when all circumstances of the case, including good commercial practice and the nature of the product, are considered.

The firm may thus not abuse its strong bargaining position, if it has one. Two examples have been mentioned in the Directive: "where an agreement mainly serves the purpose of procuring the debtor additional liquidity at the expense of the creditor, or where the main contractor imposes on his suppliers and subcontractors terms of payment which are not justified on the grounds of the terms granted to himself, these may be considered to be factors constituting such an abuse."[81]

The Directive on combating late payment in commercial transactions is complemented by two regulations that make it easier for the supplier to collect its claims from the firm.

Regulation 805/2004 creates a European enforcement order for uncontested claims. The Regulation applies in civil and commercial matters.[82] The purpose of this Regulation is "to create a European Enforcement Order for uncontested claims to permit, by laying down minimum standards, the free circulation of judgments, court settlements and authentic instruments throughout all Member States without any intermediate proceedings needing to be brought in the Member State of enforcement prior to recognition and enforcement".[83]

Regulation 1896/2006 creates a simplified system for collecting uncontested debts between Member States. This Regulation applies to civil and commercial matters in cross-border cases.[84] The purpose of the Regulation is "to simplify, speed up and reduce the costs of litigation in cross-border cases concerning uncontested pecuniary claims by creating a European order for payment procedure"[85] and "to permit the free circulation of European orders for payment throughout the Member States by laying down minimum standards, compliance with which ren-

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[76] Article 4 of Directive 2000/35/EC (Late Payment Directive).
[77] Article 5 of Directive 2000/35/EC (Late Payment Directive).
[78] Recitals 16–17 of Directive 2000/35/EC (Late Payment Directive).
[79] Article 3(1) of Directive 2000/35/EC (Late Payment Directive).
[80] Article 3(3) of Directive 2000/35/EC (Late Payment Directive).
[81] Recital 19 of Directive 2000/35/EC (Late Payment Directive).
[82] Article 2 of Regulation 805/2004.
[83] Article 1 of Regulation 805/2004.
[84] Article 2(1) of Regulation 1896/2006.
[85] Article 1(1)(a) of Regulation 1896/2006.

ders unnecessary any intermediate proceedings in the Member State of enforcement prior to recognition and enforcement".[86]

The latter Regulation lays down a standard form of order to be issued by the court having jurisdiction according to the Brussels I Regulation[87] at the request of the creditor. That order will then be served on the defendant debtor. The defendant has the opportunity to oppose the claim. If the defendant opposes the claim, the proceedings will continue before the court that issued the order as normal civil or commercial litigation. If the defendant does not oppose the claim, the order becomes enforceable.

Consignment of Goods

Some firms use the consignment of goods as a means of reducing their external funding needs. There are two or three parties to a consignment. A consignment may be used as a means of financing a purchase by the consignee.

A pure consignment occurs where: goods are supplied by a supplier to a dealer; the supplier retains title to the goods until the goods are sold or otherwise disposed of by the dealer, as authorised by the supplier; and the dealer (the consignee) does not incur any liability to the supplier for the price, unless and until the dealer sells the goods. The risk that buyers will not be found for the goods is borne by the supplier rather than the dealer, and the dealer may pay later than in normal direct sales.[88]

A consignment is thus complemented by a retention of title clause. One of the purposes of the Late Payment Directive is to make contractually valid retention of title clauses enforceable (for retention of title, see also Volume II).

If a financing party is involved, the consignment will be supported by a master agreement. Under the master agreement, the financing party authorises the consignee (for example, an equipment dealer) to buy goods from a supplier and take delivery of those goods acting as an agent for the financing party. The purchase price can then be paid by the financing party either to the supplier directly or indirectly via the dealer. Legal title is acquired directly by the financing party from the supplier. In the course of its business, the dealer is able to sell the goods to other purchasers as an agent for the financing party.

If the contract is governed by English law, the dealer can hold the proceeds of the subsale in trust as an agent and fiduciary for the financing party to the extent of the moneys paid or advanced.[89]

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[86] Article 1(1)(b) of Regulation 1896/2006.

[87] Regulation 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

[88] The Law Commission, Registration of Security Interests, paragraph 6.22.

[89] *Ibid*, paragraph 6.23.

3.4.3 Management of Accounts Receivable

Introduction

One side of the management of working capital is management of accounts payable (see above). The other side is management of accounts receivable. Accounts receivable are the key determinant of working capital.

For the seller, accounts receivable are an investment related to the last part of the operating cycle, that is, the sales of products. Accounts receivable arise from the terms of payment offered to customers, and their volume depends on the credit offered to customers.

For customers, accounts receivable are a source of short-term funding connected to the purchase of goods and services (section 3.4.2 above). Large buyers can benefit from their stronger bargaining position by paying late. Small firms must, in practice, pay earlier because of their weaker bargaining position.

The credit policy of the firm is an important way to influence its external funding needs because a major part of the assets of many firms is in receivables. A change in the firm's credit policy has a direct effect on turnover and an indirect effect on other working capital determinants and accounts receivable itself. A hard line with debtors risks alienating customers temporarily lacking cash. But if the firm is too soft, it may run short of funds itself.[90]

For the same reason, receivables form an important asset from which the firm may wish to raise funding. Receivables financing can take the form of an outright sale under arrangements commonly known as factoring and discounting of receivables. Securitisation is an advanced method of releasing capital. Securitisation means the sale of receivables to a single purpose vehicle which issues bonds in order to finance the purchase.

Alternatively, the firm may grant a security interest in the receivables (see Volume II). In practice, the distinction between the outright sale of receivables and their transfer by way of security can be blurred. If the debt is sold but on a recourse basis (so that if the debtor fails to pay, the seller must re-purchase the debt or make good the loss) or if a similar effect is achieved through warranties given by the assignor, the arrangement is functionally very much like a security interest in the receivables.[91]

In the following section, the credit policy of the firm will be discussed before factoring, forfeiting and securitisation.

Extension of Trade Credit and Choice of Payment Terms

The primary function of accounts receivable is to enable customers to buy goods and services even if they temporarily lack funds.

Suppliers extend credit to their customers for financial and commercial reasons. The financial reason is that firms that have better access to credit markets are able

[90] See Accounts not receivable, The Economist, September 2008.

[91] See The Law Commission, Registration of Security Interests, paragraphs 6.24 and 6.25.

to use their borrowing capacity to play a financial intermediary role for firms that cannot raise capital as easily. The commercial reason is that the use of trade credit (which reduces costs as well as cash requirements for customers) may be an active strategy to support sales or price segmentation (price differentiation).

Trade credit and risk. There is therefore a difference between bank credit and trade credit. A traditional creditor regards credit as a separate investment and wants that investment to be profitable. For a trade creditor the sale of goods and the extension of credit are part of the same customer relationship.

The extension of trade credit means that the firm is exposed to counterparty credit risk. A firm that sells on credit terms must usually write off some sales as uncollectible (due to the customer's insolvency) and suffer payment delays beyond credit terms.

Accounts receivable functions are closely connected with other functions such as: verification of product quality (the seller must ensure that the quality is what the seller promised[92] and that the buyer may not invoke breach of contract[93], because the buyer may otherwise have a right to refuse to pay[94]); the use of efficient payment tools (cash management); and currency management (there may be a credit arbitrage opportunity for the seller if the accounts receivable are denominated in a foreign currency).

Credit policy. The management of accounts receivable is focused on the trade-off between the incremental profits from the sales generated by the different credit policies and the costs of such policies.

The firm has many conflicting objectives. The firm tries to: maximise sales; minimise losses caused by bad debts; minimise operative credit costs; and minimise financial costs due to investment in accounts receivable.

The firm should expand credit facilities as long as the profitability of additional sales exceeds the costs of accounts receivable (financial costs, operative costs, cost of delays, credit losses). When comparing the profitability of different credit policies, the firm will take into account the following things: change in profit = change in sales revenue – change in monetary production costs – change in credit costs.

Risk categories and credit limits. Typically, the firm places its customers in different risk categories. The internal credit guidelines of the firm should set out how customers' orders can be credit approved on the basis of the risk category to which the customer belongs. Those guidelines should also set out how a credit limit is determined for each customer on the basis of the risk category of the customer.

The choice of risk category will be done in advance on the basis of the customer's estimated payment behaviour but monitored during the business relationship.

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[92] CISG Article 35.

[93] CISG Article 39(1) (notice within a reasonable time); CISG Article 39(2) (statute of limitation); CISG Article 40 (effect of knowledge).

[94] See, for example, CISG Article 50.

First, the risk category will be determined on the basis of the customer's past payment performance, financial status, field of activity, size, and home country. The firm may also rely on external credit-rating reports (see Volume I).

Second, the payment behaviour will be monitored. The risk category can be updated on the basis of changes in the estimated payment behaviour and on the basis of the customer's historical payment behaviour. For example, the firm should not extend more credit but sell only against a cash payment where the customer has exceeded its credit limit ("red light"). The firm should be more careful where a customer is close to its credit limit ("yellow light"). An adverse change in the risk profile of a customer can result in a race to collect payment or obtain more collateral.

Integration of credit management. Credit management is part of the firm's business model. The business model of the firm consists of a distribution model and a sales cycle.

The firm can sell directly to end-users or use various kinds of commercial agents or distributors. Distributorship contracts and commercial agency agreements are the most frequently used means for organising the distribution of goods in a foreign country.

A distributor can be controlled by the firm itself (subsidiary) or be independent (such as an independent sole distributor), in which case agency problems must be mitigated in other ways. Distributorship contracts are largely standardised in commercial practice.[95]

A commercial agent means a self-employed intermediary who has continuing authority either to negotiate the sale of goods on behalf of the firm (the principal), or to negotiate and conclude such transactions on behalf of and in the name of the firm.[96] Self-employed commercial agents are typically protected by mandatory provisions of law, many of which are based on the Directive on commercial agents.[97] Even commercial agency contracts are largely standardised in commercial practice in Europe.[98]

A del credere agent is one who guarantees to his principal that the third party buying the goods will perform his contractual obligations to the principal.[99]

The credit cycle starts with the conclusion of a sales contract, continues with production and distribution, and ends with credit management. The credit cycle of the firm consists of:

- the sales process (the sales process is the most important stage in credit management; the sales process ends when credit is outstanding);
- the collection process (the collection process means that accounts receivable are managed for the purpose of collection);

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[95] See, for example, the ICC Model Distributorship Contract.

[96] See section 1(2) of Directive 86/653/EEC (Directive on commercial agents).

[97] Directive 86/653/EEC on the coordination of the laws of the Member States relating to self-employed commercial agents.

[98] See, for example, the ICC Model Commercial Agency Contract and the UNIDROIT Principles of International Commercial Contracts.

[99] For German law, see § 394 HGB.

- pre-legal action (the monitoring of outstanding accounts, the focus is now on identified clients); and
- legal action (legal action is taken after customer analysis).

During the *sales process*, the firm screens its customer's past payment performance and creditworthiness in order to make credit decisions and set credit terms. Screening helps the firm to: manage its total credit exposure; minimise Days Sales Outstanding (DSO); and increase profitability.

During the sales process, the firm also decides on credit terms. The choice of credit terms should depend on the customer's estimated payment behaviour. Based on the level of trust, the firm chooses: the method of payment; to what extent the customer can order goods only within prepaid limits; credit terms including credit limits; and the terms applied when the customer fails to pay on the due date (default interest, penalties).

During the *collection process*, the firm decides to what extent it should outsource the collection process and whether it should introduce factoring. For example, the firm can buy del credere protection (insurance protection) against default.[100]

At the *pre-legal action* stage, the firm monitors identified customers. It is normal for the firm to stop further supplies if the customer fails to pay.[101] This is followed by the collection of debts. The internal credit guidelines of the firm should set out the key aspects of the recovery process of past due accounts.

At this stage, important legal questions for the firm's credit manager include: duties, if any, to notify the debtor of its breach of contract;[102] right to default interest;[103] collection and set-off rules;[104] and defences available to the debtor (in particular, breach of contract by the creditor and statutes of limitation).[105] Furthermore, the credit manager should understand the rules that govern the assignment of claims[106] as well as the rules on collateral. In the case of a race to collect payment or obtain better collateral, the credit manager should know about insolvency laws that can cause transactions to be reversed and provisions of law that that set out which creditor will prevail in the event that the same collateral has been promised to two or more creditors. Most of such questions have been discussed in Volume II.

The firm can take *legal action* if the customer still has not paid. This can be complemented by the registration of losses.

Legal aspects of payment terms. Laws generally say very little about the terms of payment offered to customers.

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[100] For German law, see § 394 HGB.
[101] The seller can usually suspend the performance of his obligations under the contract. See CISG Article 71(1) and CISG Article 71(3).
[102] For German law, see § 286 BGB.
[103] CISG Article 78.
[104] For German law, see §§ 387–396 BGB.
[105] CISG Article 50. For German law, see § 437 BGB (Mängelrüge).
[106] For German law, see § 398 BGB and § 453 BGB.

According to a traditional contract law rule, the seller is not required to hand over the goods to the buyer until the buyer has paid the price in full (cash against delivery, the Zug-um-Zug principle).

The same principle can be found in the CISG: "If the buyer is not bound to pay the price at any other specific time, he must pay it when the seller places either the goods or documents controlling their disposition at the buyer's disposal in accordance with the contract and this Convention. The seller may make such payment a condition for handing over the goods or documents."[107]

The firm would usually not rely on legal background rules. The firm prefers to regulate payment terms in the contract document or in the order confirmation. If the parties have not agreed on the payment date otherwise, the firm can usually determine it in the invoice, provided that the payment terms are not unreasonable.[108]

Agreed payment terms. There are many ways to agree on payment terms and a wide range of payment terms. (a) The purchase price may be payable in advance, on delivery, or after delivery. Sometimes one or more parties must provide adequate security. (b) The customer may be asked to pay on a certain date or within a certain number of days after delivery, data of invoice or another date. The firm may demand payment of the purchase price in advance or extend credit after provision of what the firm considers to be adequate security. (c) There can be an express payment term in the sales contract. Alternatively, the firm can ask the customer to pay the amount shown on the invoice within the payment period shown on the order confirmation. The payment term can also be found on the invoice. For example, the firm may ask the customer to pay within a certain number of days after date of invoice. (d) Payment can be supported by usual commercial terms of documentary credit such as irrevocable letters of credit, cash against documents or cash against delivery.

Payment practices, choice of payment term. How will the firm choose the payment term? The choice of payment term depends on the transaction, the country, the customer, and the prefences of the firm. For example, business practices in the customer's home country are bound to influence the payment term: if the payment becomes due earlier than is regarded as customary in the buyer's country or earlier than the buyer would accept, there is an increased risk of default.

European payment practices depend to a very large extent on the country and the type of customer:

- Small customers that are in a weaker bargaining position can be made to pay faster than large firms that are regular customers.
- Standard payment periods are shorter in the Nordic countries than in southern Europe.

[107] CISG Article 58(1).
[108] Compare CISG Articles 58, 55 and 7.

- The share of customers paying on or before due date is larger in the Nordic countries than in sourthern Europe.
- After the due date, customers still pay faster in the Nordic countries than in southern Europe.
- The extension of credit is safer in OECD countries than other countries.
- The firm should use a letter of credit or require advance payment in developing countries.

There are differences in payment practices in individual Member States (see also Volume II). Payments are typically made: within 30–60 days in the UK, the Netherlands, Germany and Belgium;[109] within 60–90 days in Italy, Spain and France; and within 90–120 days in Portugal. Payments are made faster and more reliably in the Nordic countries.

The firm can expect some correlation between counterparty credit risk and the level of "sleaze" in the customer's home country (see Volume II). A bad ranking in the Transparency International corruption index indicates that the customer's country risk is high and that the firm may need to require advance payment or an irrevocable letter of credit.

Usual payment terms include: open-account trading with an agreed payment period; the simultanenous exchange of goods for money (cash on delivery); the simultaneous exchange of documents controlling the disposition of the goods for money (cash against documents); and advance payment.

Open-account trading is widely used for trade between western European countries. The supplier agrees to open-account trading, if it is confident that the risk of not being paid is small.[110]

The simultaneous exchange of goods for money is typically used in mass transactions such as consumer sales and generally where the seller can hand the goods over to the buyer.

Where the goods are shipped to the customer, the method of cash against documents can be used instead. Cash against documents is used in particular where the goods are sold to a business customer and the goods are commodities that can just as easily be sold to another customer if one customer fails to pay.

It is characteristic of the cash against documents term that banks are used as intermediaries (for the mitigation of credit risk in trade finance, see Volume II).

In documentary collection, the supplier retains control of the goods by not handing over the transport documents (for example, the bill of lading) until the buyer pays (documents against payment, D/P) or obliges itself to pay by accepting a bill of exchange (documents against acceptance, D/A).[111] Documentary collection requires a certain degree of trust, because the goods will already have been shipped to the buyer before it becomes clear whether the buyer will actually pay.

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[109] See Dun & Bradstreet, Payments Performance (2003).
[110] Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) p 377.
[111] *Ibid*, p 377.

If the supplier chooses a letter of credit instead of documentary collection, the goods will not be shipped to the buyer unless a bank has already paid. Less trust is therefore required. Letters of credit are often used in developing countries.

In all forms of cash against documents, the goods will be in existence before payment is made. If this is a problem, the supplier may prefer payment in advance.

Payment in advance occurs frequently in situations where expensive goods are manufactured to the specifications of the buyer. For example, advance payments are used in contracts for the building of ships or aircraft. The buyer will often not agree to advance payment unless the supplier provides a demand guarantee.

In transactions that involve the sale of an expensive item that is tailor-made for the buyer and installed by the seller (for example, large diesel engines for ships), the parties often agree to apply the cash against delivery principle (the Zug-um-Zug principle)[112] in the following way: (1) The price is paid in instalments. (2) The seller becomes entitled to each instalment after fulfilling a certain part of its obligations under the contract. (3) If the parties agree that the buyer pays something in advance, the parties usually agree that the seller shall furnish a guarantee (often a so-called demand guarantee). (4) These are the usual stages: pre-installation period (payment: _%); installation period (payment: _%); testing period (payment: _%); agreed delivery date; acceptance of delivery (payment: _%); effective delivery date (if the effective delivery is later than the agreed delivery date, the buyer may be entitled to liquidated damages – if the parties have agreed on liquidated damages – and termination); and warranty period and maintenance period (payment: _%). (5) Trade debts are often secured by a retention of title clause (see Volume II).

Default interest. There are many ways to reduce counterparty credit risk and the risk of payment default (Volume II). For example, the parties may agree on collateral and remedies available to the supplier in the event of default. The contract usually provides for default interest in the event that the customer fails to pay on time.[113] Default interest is usually higher than the normal interest rate.

For example, the parties may agree that if the customer fails to pay the invoice in full within the payment period, the customer will automatically be in default without any notice of default or further warning being required. The parties may also agree that the firm as the seller may charge interest without further notice. The parties may choose a fixed interest rate for payments in arrears or decide to use a variable interest rate (for example, the European Central Bank's refinancing rate plus a surcharge of 7% in the same currency as the amount invoiced to the customer).

Unreasonable payment terms are generally prohibited in most jurisdictions (see Volume II).

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[112] CISG Article 58.

[113] CISG Article 78 also contains a rule on interest: "If a party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest on it, without prejudice to any claim for damages recoverable under article 74." However, the CISG is silent on the interest rate. The interest rate thus depends on the governing law and the terms of the contract.

For example, Anglo-American law restricts the use of "penalty clauses". Anglo-American law will strike down a stipulated payment as a penalty, where it is extravagant or unconscionable in relation to the other party's greater loss, or where it is not a genuine pre-estimate of that loss. Default interest clauses have been treated as penalties when the higher rate is payable for both the interest period and the period of default from the due date. On the other hand, many default interest clauses are not prohibited. There is no penalty if the clause provides for a reduction of interest on punctual payment. There is no objection if the default rate is modest and is confined simply to the period from the due date (the increased rate payable by the debtor is justified because, being in default, the debtor is now a worse credit risk).[114]

Community law. In the EU, the Late Payment Directive[115] prohibits the use of abusive contract terms on interest (see section 3.4.2 above). Article 3(1) sets out the main rules on the duty to pay interest for late payment. Article 3(3) restricts the use of contract terms that are not in line with those provisions.

Factoring

After doing what it can to reduce accounts receivable, the firm can reduce its working capital further by introducing factoring. Legally, factoring means that the firm's trade debts are bought by a factor. Ownership of those debts is transferred to the factor by way of an assignment (for the assignment of claims, see Volume II).

Major banks usually have subsidiaries involved in factoring business debts. Financially, factoring is a form of accounts receivable financing. Factoring companies also provide a wide range of other factoring services.

Functions of factoring. Factoring may therefore have different functions (finance, del credere, services). The factor may merely provide a service of collecting the debts, or it may advance money to its client in advance of the debts being collected.[116] In addition, there are different forms of factoring (recourse factoring or non-recourse factoring, full factoring or confidential invoice discounting).

Finance function. Factoring affords the firm the opportunity to sell its trade debts at a discount to factors or to use them as a security (finance function). This will improve cash-flow.

The firm will obtain funds faster, because the firm is no longer dependent on the conversion of accounts receivable to cash from the actual payment from their customers, which takes place on, say, 30 to 90 day terms.

The factor will offer the firm a cash percentage of the face value of the receivables. For example, factors might advance up to 80% of invoice value.[117]

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[114] Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) pp 310–311.

[115] Directive 2000/35/EC (Late Payment Directive).

[116] The Law Commission, Registration of Security Interests, paragraph 6.26.

[117] See Finch V, Corporate Insolvency Law. Perspectives and Principles. Cam U P, Cambridge (2002) pp 112–113, citing a Bank of England study from 1998.

Factoring and invoice discounting are devices of particular value to small, fast-growing companies that experience late payment problems and wish to release funds tied up with debtors for use as working capital. Factoring and invoice discounting tend to prove more expensive than bank financing but they allow businesses to grow in line with their sales. They can also be useful when the firm has exhausted its overdraft facilities and cannot raise more equity from shareholders.[118]

Recourse factoring or non-recourse factoring. There is a distinction between recourse factoring and non-recourse factoring.

With non-recourse factoring, the factor absorbs the losses on bad debts, or at least on some of them (del credere function). Non-recourse factoring is sometimes called "genuine factoring".[119]

Recourse factoring enables the factor to recover from its business customer's account moneys advanced against what turn out to be bad debts. Recourse factoring is the most common type of factoring transaction but not as "genuine factoring" as non-recourse factoring.[120]

For example, in the case of *MKG-Kraftfahrzeuge-Factoring GmbH & Co. KG*,[121] the factoring KG had agreed with a GmbH to purchase, within a framework laid down by it in advance in each case, the debts owed to the GmbH by dealers arising from vehicle deliveries. The factoring KG assumed the risk of default inherent in the debts acquired by it in that way without a right of recourse against the GmbH. The del credere took effect if a dealer failed to pay the relevant invoice 150 days after it was due. The factoring KG also agreed to recover the remainder of the GmbH's debts, but with a right of recourse against it, and to manage the debtor accounts and provide M-GmbH with documents allowing it to ascertain the position with regard to its business relations with each debtor. The factoring KG paid to the GmbH the face value of the debts purchased by it in each calendar week, less agreed charges, on the third working day of the following week. The agreed charges comprised factoring commission of 2% and a del credere fee of 1% of the face value of the debts.

Full factoring or confidential invoice discounting. There is also a distinction between full factoring and confidential invoice discounting. In full factoring, the factor provides sales accounting functions, and the customers of the firm are informed that their invoices have been assigned (notification). In confidential invoice discounting, neither occurs, and the firm continues to collect payments from its customers, but on the factor's behalf.

Factoring and forfaiting. Forfaiting is a device that resembles factoring. It means the discounting of individual bills of exchange or promissory notes on a non-recourse basis. Forfaiting is typically used in large export trades (see below).[122]

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[118] *Ibid*, pp 112–113.

[119] In German: echtes Factoring.

[120] In German, it is called unechtes Factoring.

[121] Case C-305/01 Finanzamt Groß-Gerau v MKG-Kraftfahrzeuge-Factoring GmbH & Co. KG [2003] ECR I-6729.

[122] See Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) p 382.

Factoring and block discounting of receivables. Block discounting is basically a form of factoring.[123] In the British market, block discounting refers to a form of discounting of consumer receivables. It is used by traders who supply goods to consumers on hire-purchase, credit-sale or rental and wish to obtain immediate payment instead of collecting instalments and rentals as they fall due.

The block discounting agreement is a master agreement which fulfils the same function as a factoring agreement. Under the block discounting agreement, the trader sells its rights under certain contracts to a finance house at their discounted value. Agreements are sold or offered for sale to the finance house in batches ('blocks') at agreed intervals. The trader guarantees performance by its customers and gives the finance house an indemnity against loss. No notice of the assignment is given to the customer, because the trader does not want customers to know of the involvement of the finance house and the finance house does not want the bother of collecting large numbers of consumer receivables unless the trader defaults.

This means that, under English law, the assignment of the receivables takes effect "in equity" only and is an "equitable assignment" rather than a "legal assignment". For the enforcement problems caused by lack of notice, see Volume II.

Costs and benefits. The price paid by the factor is the nominal value of the receivables less costs (including financing costs for earlier payment) and a premium for default risk. Payment terms can depend on whether the parties have agreed on recourse factoring or non-recourse factoring. For example, the factor can pay the purchase price in full in non-recourse factoring. In recourse factoring, the factor may prefer to pay, say, 90% of the price immediately and the remaining 10% to the extent that debtors have paid up.

Although factoring can be expensive, factoring can bring many benefits. (a) Banks usually seek to take collateral in order to mitigate the risk of default, but factors neither lend money to clients nor seek collateral, additional to the assignment of the invoice. (b) Factors may also offer one or a combination of credit management services (service function): collect payments from their customers; pursue late payers; provide advice to clients on credit management; and protect the firm against bad debts. (c) The cost of hiring a qualified credit controller is mitigated by using a factor. (d) The use of professional credit management services often results in invoices being paid more quickly. (e) The factoring of an invoice and the money paid by the factoring company can make it easier for the firm to qualify for a supplier discount (perhaps as high as 5% of gross invoice value) for prompt payment.

Legal aspects. Legally, factoring is a sales contract between a buyer (the factor) and a seller (the client firm) and means the assignment of certain receivables. As

[123] See The Law Commission, Registration of Security Interests, paragraphs 6.28 and 6.29.

the receivables are assigned to the factor, the factor has the right to proceed directly in its own name against the debtors.[124]

The factor needs to mitigate the risk that the client firm only sells bad debts (for ways to rise above the "market for lemons", see Volume I). The factor often prefers to conclude a master agreement, according to which the client firm will sell all receivables that meet certain criteria and that the factor will manage the receivables that have been assigned to it. The factor can further mitigate the risk of bad debts by choosing recourse factoring. On the other hand, recourse factoring can increase other legal risks.

In Germany, recourse factoring (also called "unechtes Factoring", "not genuine factoring") means a loan agreement between the factor and the customer firm complemented by a collection service and the assignment of receivables by way of security.

In the master agreement, the parties agree, for example: that the firm is responsible for the existence (in Latin: veritas) of the receivables that it sells to the factor; on price and other limits regarding the underlying customer contracts; on distribution of risk in the case of default by the firm's customers (recourse or non-recourse); on fees; on the duty of the firm to assign all receivables that meet the agreed criteria; and on global assignment to the factor of all receivables that meet the agreed criteria.

Factoring builds on the basic legal principles for transferring receivables:[125] (1) Receivables can be assigned, if the assignor (the client firm) and the assignee (the factor) agree on the assignment, provided that the assignment of the debt is not prohibited according to its terms. (2) If the debtor (the firm's customer) and the firm have agreed or the law says that the debt cannot be assigned without the consent of the debtor or otherwise, the assignment is not effective in relation to the debtor. (3) Usually, the law does not prevent the assignment of trade debts. (4) Usually, receivables may be assigned without the consent of the debtor, unless the assignment is prohibited by law, contractual non-assignment clauses, or the nature of the receivable. If there is a contractual prohibition on assignment, the sale of receivables is ineffective against the debtor, but the contractual undertaking of the seller to assign the receivables to the purchased pursuant to the sale agreement can be valid and effective as between the seller and the purchaser. Since the sale cannot be completed if the receivable contract prohibits the assignment, the seller will be liable to the purchaser for damages incurred by the purchaser due to the breach of non-performance of its obligations under the sale agreement. (5) The assignee (the factor) cannot rely on the assignment of the debt in relation to the debtor (the client firm's customer), the assignor's creditors (the client firm's creditors) and other third parties, unless the debtor (the client firm's customer) is notified of the assignment. (6) It is therefore legally important to notify the client firm's customers of the assignment.

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[124] See, for example, § 398 BGB: "Eine Forderung kann von dem Gläubiger durch Vertrag mit einem anderen auf diesen übertragen werden (Abtretung). Mit dem Abschluss des Vertrags tritt der neue Gläubiger an die Stelle des bisherigen Gläubigers."

[125] See, for example, Cranston R, *op cit*, p 355.

As regards transaction finality, one of the most important questions for the factor is whether the assignment of receivables can be enforced against original debtors (the client firm's customers) and the client firm's creditors in the event of the client firm's insolvency (see Volume II). In continental European laws, the basic distinction would be that between contract law issues and proprietary rights issues ("Sachenrecht"). Insolvency laws would also play a role. In England, the factor would ask whether the assignment is "legal" or "equitable". In England, a sale of receivables even with recourse is not a loan secured on the receivables (a loan secured on the receivables would require registration as a charge) and can thus be regarded as a legal assignment.[126]

This is how The Law Commission described the difference between legal and equitable assignments: "An assignment may be either legal or equitable and the relevant interest may also be legal or equitable. Once there has been a legal assignment, the factor acquires the legal right to the debt (subject to equities having priority), all legal and other remedies for the debt and the power to give a good discharge for the debt without the concurrence of the assignor. However a legal assignment requires a writing under the hand of the debtor and express notice in writing to the debtor, and it cannot be effective until the debt comes into existence. An equitable assignment, in contrast, can be of future debts and may be purely informal without even notice to the debtor. However a debtor who pays the assignor before learning of the assignment will be discharged. For this and other reasons a factor may still want to give notice of an equitable assignment to the debtor. In contrast to an assignment at law, any form of notice is sufficient, provided the fact of the assignment is definitely brought to the mind of the debtor. It is sufficient to show that the debtor has had knowledge of the assignment, regardless of the mode or source of that knowledge."[127]

International factoring. The firm may have even more reason to use factoring in export trade, because the firm typically has less connection to a foreign market with its foreign laws than the firm's home market with its local laws. The basic principles of international factoring are the same as those of domestic factoring. International factoring is nevertheless more complicated. Typically, the firm sells receivables located in a certain foreign country first to a domestic factor. The domestic factor sells the receivables to a second factor located in that foreign country (correspondence factor or import factor).

In the Member States of the EU, the governing law is determined by the Rome I Regulation:[128] the relationship between the factor and the debtor (the client firm's customer) is governed by the law that governs the contract between the client firm and the debtor;[129] the relationship between the factor and the client firm is governed, in the absence of choice, by the law of the country where the factor has its place of business;[130] the relationship between the import factor and the export

[126] See The Law Commission, Registration of Security Interests, paragraph 6.35.

[127] The Law Commission, Registration of Security Interests, paragraph 6.27.

[128] Article 24(1) of Regulation 593/2008 (Rome I): "This Regulation shall replace the Rome Convention in the Member States …", Article 28: "This Regulation shall apply to contracts concluded after 17 December 2009."

[129] Article 14(2) of Regulation 593/2008 (Rome I).

[130] Articles 4(1)(b), 4(2) and 14(1) of Regulation 593/2008 (Rome I).

factor is governed, in the absence of choice, by the law of the country where the export factor has its place of business.[131]

There have been some attempts to simplify the legal rules that govern international factoring. (a) The purpose of the 1988 Ottawa Convention on International Factoring was to simplify the assignment of debts in international goods and services transactions and to facilitate export financing. However, the Ottawa Convention has been ratified only by a handful of countries.[132] (b) The United Nations Convention on the Assignment of Receivables in International Trade was adopted in 2001. The main objective of the UN Convention is to promote the movement of goods and services across national borders by facilitating increased access to lower-cost credit. In order to achieve this objective, the Convention removes legal obstacles to certain international financing practices such as asset-based lending, factoring, forfaiting, securitisation, refinancing and project financing. However, the UN Convention has not yet entered into force.

Forfaiting

Forfaiting means the practice of discounting of individual bills of exchange or promissory notes originating from commercial business transactions on a non-recourse basis. Forfaiting is often used for large transactions in export trade.

Forfaiters will sell the bills and notes they have discounted.[133] For example, DF Deutsche Forfait AG, a German financing company, holds a bill of exchange for 14 days on average before selling it further.[134]

The forfaiter purchases account receivables at an agreed discount interest rate. These are discounted and the net amount is placed at the disposal of the supplier. The supplier thus receives immediate payment.

The discount reflects the risk the forfaiter is taking. Central to forfaiting is that the supplier will have drawn the bill "without recourse" and that there is an aval (see below) or a guarantee on the bill. This will usually be provided by a leading bank in the buyer's country. The forfaiter will rely primarily on the guarantee or aval of the bank in the buyer's country in the event of non-payment by the buyer.

The guarantee or aval is also necessary for the marketability of the paper, since without the name of a leading bank on it, the forfaiter would not be able to sell it in the secondary market. After purchasing the bill of exchange, the forfaiter may enhance the credit obligation by structuring credits better and/or by taking out credit insurance.

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[131] Article 4(2) of Regulation 593/2008 (Rome I).

[132] France, Germany, Hungary, Italy, Latvia, Nigeria, Ukraine. See, for example, Basedow J, Internationales Factoring zwischen Kollisionsrecht und UNIDROIT-Konvention, ZEuP (1997) pp 615–642.

[133] See Cranston R, *op cit*, pp 382–384.

[134] Deutsche Forfait will and die Börse. Kapitalerhöhung in zweistelliger Millionenhöhe, FAZ, 7 May 2007 p 15.

Approximation of laws. The legal aspects of forfaiting depend on the regulation of bills of exchange. One could say that there are two main legal systems which regulate the law of bills of exchange.

The first group covers the countries which adopted the 1930 Geneva Uniform Law on Bills of Exchange and Promissory Notes. The Geneva Uniform Law is mainly based on French and German law. This system is adopted in most civil law countries.

The second system applies in common law countries. It is based on the English Bills of Exchange Act 1882 and the American Uniform Negotiable Instruments Act 1896 (which was later replaced by section 3 of the UCC).

There are some important differences between those two systems.[135] In the civil law system, the bill of exchange is subject to strict rules regarding its form and content. In the common law system, those rules are more flexible. For example, article 1 of the Geneva Uniform Law requires that the term "bill of exchange" be inserted in the document. No such requirement exists in the common law system. In common law, there is even a special kind of bill of exchange called "promissory note".

In the civil law system, the obligations arising from the bill of exchange are unconditional.[136] Under common law, the obligation from a bill of exchange can be made subject to performance of another obligation.[137]

An aval is a special kind of guarantee instrument recognised in the Geneva Uniform Law, that is, the civil law system.[138] The giver of an aval is bound in the same manner as the person for whom it has become guarantor. For example, if the buyer has accepted the bill, the bank avalizing the bill for account of the buyer assumes the liability of an acceptor.[139]

3.4.4 Particular Aspects of Securitisation

Introduction

There are two typical motivations for the issuance of asset-backed securities: fund raising and credit risk transfer. Both can be achieved either through a true sale securitisation or through a funded synthetic securitisation.

Securitisation is a financing technique that allows asset-rich firms to raise lower-cost funding from the capital markets. From the perspective of the firm, it could be described as a sophisticated form of factoring or discounting of debts.

The term "securitisation" describes a process whereby the revenue stream on a segregated pool of receivables or other income producing assets, rather than being

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135 Pejovic C, Civil Law and Common Law: Two Different Paths Leading to the Same Goal, Victoria U of Wellington L R (2001) 32 pp 817–841 at 829–830.

136 Article 26 of the Geneva Uniform Law.

137 For example, section 19 of the Bills of Exchange Act 1882 provides that the acceptance may be conditional.

138 Article 31 of the Geneva Uniform Law.

139 See Cranston R, *op cit*, pp 382–384.

assigned as security, sold to individual financiers, or held by the firm to generate a flow of income, is repackaged into tradeable securities issued to investors. The identity of the investors may change over the life of the securities.[140]

Securitisation is not limited to debts. Almost any types of assets can be securitised, provided that the assets produce an income stream and the cash flow can be determined in advance (loans, commitments, asset-backed and mortgage-backed securities, corporate bonds, equity securities, private equity investments, and so forth).[141] For example, the best-known copyright securitisation deal is the issue in 1997 of USD 55 million worth of bonds supported by the future sales of music by David Bowie, a British rock star ("Bowie Bonds").

According to the ECB, the size of the euro-denominated securitisation market had a global outstanding volume of €0.8 trillion as at the end of 2006. The overall US securitisation market (defined as the securitisation market with an originator located in the US) was much larger than the European one and stood roughly at USD 8.6 trillion (€6.5 trillion equivalent).[142]

Structure. Securitisation rests on a complex legal foundation. The main parties to a securitisation transaction are the originator, the special purpose vehicle (SPV), the security trustee, the administrator, and investors.

A standard securitisation transaction will involve the sale of receivables (the asset pool) by the owner (the originator) to a purchaser, often a specially incorporated company or a specially established trust (the SPV). The SPV is structured (a) so that it will not be affected should the originator become insolvent (bankruptcy remoteness) and (b) so that the assets will be derecognised (see section 3.3.2 above). The SPV will fund the purchase through the issue of debt securities. The securities are backed by the asset pool in two ways: (a) their interest and principal payments are closely linked to the interest and principal received on the pool of assets; and (b) they are secured on the receivables by virtue of a security interest granted to an intermediary, often a security trustee which acts for the investors in the debt securities.[143] As a result of securitisation:

- the originator obtains money from the transfer of the assets to the SPV;
- the SPV holds the assets and uses the income from the assets to fund its own borrowing;
- the borrowings of the SPV will be secured on the assets and therefore will carry a lower rate of interest than unsecured borrowings;

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[140] The Law Commission, Registration of Security Interests, paragraph 6.30.

[141] Paragraph 542 of the Basel II Accord. Kroll MJ, Bürgi JA, Sauter UC, Securitisation in der Schweiz, IFF Forum für Steuerrecht 2002 p 252: "Als möglichen Aktiven kommen praktisch alle denkbaren Finanzaktiven in Betracht. So wurden in der Schweiz bisher unter anderem folgende Aktiven verbrieft: Handelsforderungen, Leasingforderungen, Hypothekarkredite, Warenlager, Forderungen aus Sport-Vermarktungsverträgen, Settlement-Risiken, Forderungen aus der Benutzung von Warenhauskreditkarten etc."

[142] ECB, The euro bonds and derivatives markets (June 2007) p 25.

[143] The Law Commission, Registration of Security Interests, paragraph 6.31.

- the risks in the original assets are removed from the originator;
- if the assets are bank loans, the originator has reduced its lending exposure and is thus permitted by banking regulations to make further loans;
- the assets have been transformed into tradeable asset-backed securities; and
- the credit quality of the asset-backed securities is solely based on the characteristics of the asset pool and not related to the creditworthiness of the originator.

In a funded synthetic securitisation process, the ownership of the asset pool is not transferred to the SPV, but remains on the balance sheet of the originator. The risks associated with the asset pool are nevertheless transferred to the SPV by means of a credit derivative.

Reasons to use securitisation. The firm (the originator) can benefit from securitisation in many ways.[144] The benefits of securitisation range from balance sheet considerations to risk transfer (for the management of risk through special purpose vehicles, see Volume II).

Availability. As the securities are legally issued by an SPV rather than by the firm itself, securitisation can be used not only by listed companies but also by unlisted public limited-liability companies, private limited-liability companies, public sector entities, and other legal entities with a sufficiently large pool of homogeneous assets that generate income.

Balance sheet. One of the principle benefits of securitisation is to remove the securitised assets from the originator's balance sheet, with the proceeds then appearing as cash. Balance sheet considerations play an important role in securitisation.

Cost. In principle, securitisation might help the firm to reduce the cost of funding. The purpose of securitisation is to convert cash flows from underlying assets or receivables due to the entity that owns them into a smooth and predictable repayment stream. Securitisation can help the firm to obtain a higher credit rating for the asset-backed securities issued by the SPV and lead to a lower cost of funding through credit arbitrage.

First, the asset-backed securities may be regarded as a better credit risk than the originator itself. Second, the originator may be owed debts by other companies that are regarded as a better credit risk than the originator itself. If the originator can borrow money solely against the credit risk of those receivables it will, in theory, be able to borrow more cheaply than if its lenders have to take the risk of the originator's own default as well as any risk involved in the receivables. Third, the asset-backed securities may be a better credit risk than the firm's financial intermediaries (banks and other lenders). Fourth, tranching (see Volume II) and the use of the equity technique (section 5.1) will enable price segmentation of securities.

Regulatory capital. For banks and financial institutions, securitisation can be a way to manage regulatory capital. Modern banks package loans as tradeable

[144] *Ibid*, paragraph 6.32.

securities and sell them on rather than hold loans on their books. Exposures related to securitisation have been dealt with in Chapter IV of the Basel II Accord.

This aspect of securitisation was partly to blame for the subprime mortgage crisis. Banks used securitisation to pass on credit risk to investors. Securitisation weakened banks' incentives to monitor the quality of the mortgage loans they wrote. This lead to degraded credit quality. After the subprime mortgage crisis, it was believed that credit quality could be increased by making originators hold on to a greater proportion of assets or the equity tranche of bonds issued by the SPV.

Risk transfer. Securitisation can generally be used as a risk management tool. It enables the originator to transfer the risk inherent in future cash flows to investors. The allocation of risk and income is a matter of contract. The originator can transfer risk completely or partially. The same can be said of the transfer of income. For example, the parties may agree that the originator will continue to retain the benefit of the surplus income from the assets and must only bear losses up to a pre-determined limit.

Other reasons. There may also be other reasons to use securitisation. This can be illustrated with the case of English football clubs.[145]

English football clubs are high-risk firms that need to invest in football stadiums. Shareholders' capital is expensive. An alternative to shareholders' capital is to borrow from banks. However, there is a problem. Banks will ask for a relatively high interest rate to reflect the high risk of lending to football clubs. They will also typically want to restrict the loan period to between 5 to 10 years. Banks will also want security for their loans as well as a suitable range of financial covenants, which would hamper managerial freedom. The restrictive nature of bank borrowing and the relatively limited availability of bank lending have meant that clubs have been willing to consider other options such as securitisation. IN theory, securitisation could bring many benefits. It could: lower the costs of borrowing; offer longer-term loans (for example, up to thirty years); encourage investment from a wider range of investors; and offer the clubs' directors more managerial freedom than would be the case with typical bank covenants. With the availability of long-term securitised funds, clubs would no longer have to finance their capital investment by short-term bank loans, but could match their long-term debt obligations by long-term revenue streams (mainly from gate receipts). Working capital could therefore be used to finance shorter-term investments such as buying new players.

Overview of Legal Problem Areas

Securitisation is a large and complex area of legal practice which raises numerous legal problems.[146] The structuring of the transaction should address them (for structuring, see below). Generally, legal problems can relate to the following aspects. Some of them will be discussed in more detailed on the following section.

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[145] See Burns T, Structured Finance and Football Clubs: An Interim Assessment of the Use of Securitisation, Entertainment and Sports L J, December 2006.

[146] For risk management, see Basel Committee on Banking Supervision, Asset Securitisation. Supporting Document to the new Basel Capital Accord (January 2001) (Second Consultative Paper).

Information about the underlying assets. Layers of securitisation tend to separate the original lender or broker of a loan from the ultimate bearer of credit risk. This makes it challenging for investors to assess the quality of information about the quality of the underlying assets and particularly challenging to regulate the responsibility for the accuracy and usefulness of information.

Transfer of ownership of receivables. The transfer of title to receivables requires a contract between the parties (the originator and the SPV). However, protection against third parties typically requires notification to debtors (usually the originator's customers) in addition to a valid contract between the originator and the SPV. There may even be other requirements as to form.

Finality of the sale. A traditional securitisation transaction will collapse, if the sale of the assets to the SPV is not valid and enforceable. This raises two questions. Is the sale of receivables to the SPV a "true sale" or not? Will it be recharacterised as something else? Whereas a real sale typically is effective between the parties and in relation to third parties, a mere assignment by way of security is not always effective in relation to third parties and the originator's customers. This risk materialises especially in the event of the originator's insolvency.

The SPV. The SPV has no assets of its own. It issues securities to finance the deal. The cash flows from the originator's customers to the SPV should match the SPV's administrative costs and payments to investors. The latter should therefore be contractually aligned with the former.

Ownership of the SPV. In a traditional "true sale" securitisation transaction, the SPV cannot be owned by the originator, because this would lead to consolidation of balance sheets and capital would not be released at all.

Balance sheet. IFRS have changed the accounting treatment of special purpose vehicles.[147] The IFRS principles take a stricter view on *derecognition* (see section 3.3.2) and *consolidation* compared with the earlier rules.

Banking laws and tax. The SPV is typically founded in a jurisdiction where the SPV is not regarded as a financial institution that has to comply with minimum capital rules and where SPV is not liable for tax (in the Netherlands, Ireland, the Channel Islands, etc).

For this reason, it was proposed by many after the subprime mortgage crisis that the minimum capital rules for banks should have a wider scope.

Security rights to the receivables sold to the SPV. It is normal to employ a so-called trust construction. However, the trust is a common law concept. It is unknown to the laws of continental European countries. It should therefore be carefully examined whether the trust construction is recognised and enforceable not only in common law jurisdictions but also in the relevant civil law jurisdictions.

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[147] IAS 39 (Financial Instruments: Measurement and Recognition); IAS 27 (Consolidated and Separate Financial Statements); and SIC-12 (Consolidation—Special Purpose Entities).

Security arrangements generally. Security arrangements are, to a large extent, governed by the law of the place where assets are located and the laws of the court having jurisdiction in insolvency proceedings (lex fori, see Volume II). It should therefore be carefully examined how the security arrangements can be made effective in the insolvency of the parties.

Governing laws. The legal framework can be governed by the laws of many countries. This increases increases documentation risk and legal risk in general.

- The *documentation* is generally governed by the law chosen by the parties.[148] Because one of the purposes of the transaction is to issue bonds in the capital market, the transaction is often governed by English law or the law of New York. This can enable the parties to mitigate investors' exposure to legal risk in general as well as to increase the legal transparency of the transaction and make the legal framework of the transaction more coherent.
- However, the *receivables* to be assigned are in effect governed by the laws of the originator's and its customers' home country under the Rome I Regulation. Whether the receivables can be assigned depends on the law that governs the receivables (customer - originator).
- The *assignment* of the receivables (originator - SPV) is usually governed by the law chosen to govern most contracts in the transaction. This could be English law or the law of New York.
- The *bonds* are usually governed by the securities market laws of the market where they are issued, and the law that governs contractual issues is often English law or the law of New York.
- Whether *security rights* are effective is governed not only by the law that governs contractual issues but also by the law of the place where the assets are situated.
- The *company* law aspects are governed by the law of the country where each company is registered.
- All courts apply the *procedural* law of the country where the court is situated (lex fori). Rights in *insolvency* are governed by lex fori.
- Each country applies its own *tax* laws and *administrative* laws.

In *Germany*, the TSI securitisation platform provided by True Sale International GmbH is a way to mitigate such legal risks. The TSI securitisation platform is a standardised securitisation process open to all market participants. TSI SPVs and securitisation transactions are based on *German law*. For this reason, German banks do not need to use foreign SPVs.

Insolvency laws. All contractual arrangements should of course be effective when it counts the most, that is, in insolvency. There are differences between different countries' insolvency laws.

Recharacterisation in general. Courts and administrative authorities can change the way they interpret laws and administrative provisions, and also aspects of the

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[148] Article 3 of Regulation 593/2008 (Rome I).

transaction can be interpreted in an adverse way. This recharacterisation can lead to a material adverse change for the parties.

Particular Legal Questions

Some of the legal questions that the originator will particularly focus on include questions of bankruptcy remoteness, true sale, priority, credit enhancements, and covenants.

Bankruptcy remoteness. Every securitisation structure must satisfy the essential condition of bankruptcy remoteness if it is to achieve the underlying objective of releasing capital and providing funding at lower cost.

Buyers of asset-backed securities try to obtain security which is wholly insulated from the fortunes of the originator itself. The originator should not - directly or indirectly – be liable as a borrower of the amount lent to the SPV.[149] For this reason: (a) the value of asset-backed securities should not be capable of being affected by the originator's insolvency; (b) the security should not be dependent upon any promise by the originator to repay the lending; and (c) there should not be any requirement for the originator to underwrite the repayment of the lending.

Limited recourse. Because of that essential condition, one of the things characteristic of securitisation is limited recourse. On one hand, the originator tries to make sure that the creditors of the SPV have no recourse to the originator in the insolvency of the SPV. The SPV is incorporated as a separate company not owned by the originator, and the originator tries to avoid or minimise the organisational links between the two entities. On the other, the separate legal personality of those two entities works both ways. It makes it difficult for creditors of the originator to make successful claims on the assets of the SPV should the originator become insolvent.

Because of limited recourse, both the quality (rating) of receivables sold to the SPV and the quality (rating) of bonds issued by the SPV play a central role in the pricing of the bonds by investors. The originator and the SPV can also put in place credit enhancement measures at the time of the deal to obtain a better rating (see below).

True sale and enforceability of the sale. Sometimes the sale is not enforcable. In particular, the sale might sometimes be regarded as an (unenforceable) assignment by way of security rather than a (normal and enforceable) sale.

According to the English way of thinking, the assignment of receivables is subject to what is known as recharacterisation risk. Recharacterisation risk means that parties with competing interests in the receivables will say that the transaction was not a sale at all, but rather a secured financing arrangement that was not properly perfected. Achieving a "true sale" means that the transfer of receivables will survive the insolvency of the originator and that the assets cannot be clawed back by means of recharacterisation.

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[149] MBNA Europe Bank Ltd v HM Revenue & Customs [2006] EWHC 2326 (Ch).

In the light of continental European laws, the question would again be whether the requirements as to form have been fulfilled. There are more requirements as to form where the transaction is regarded as a provision of security interests in the receivables. Recharacterisation would therefore be an issue also under continental European laws.

Achieving a true sale and thus avoiding recharacterisation is not only a matter of ensuring that the basic requirements as to form have been complied with. It may involve even other aspects of the transaction such as recourse to the originator, representations and warranties given by the originator to the SPV, and the parties' intent.[150] It is particularly difficult to mitigate the recharacterisation risk and similar risks when the assets to be securitised consist of future receivables that have not been earned yet (for the assignment of future receivables, see Volume II).[151] The assignments are typically supported by categorical opinions from the lawyers responsible for their design and implementation to the effect that they constitute "true sales" rather than assignments by way of security.[152]

Priority. A particular problem for some forms of securitisation relates to the way in which priority can depend upon the date on which notice was given to the debtor. For legal reasons, the debtors should be given notice of the sale of their debts.[153]

In practice, however, notice is not normally given to debtors because of administrative burdens and because the originator may wish to maintain a commercial relationship with the debtors and to continue to collect the receivables.

If no notice is given to debtors of the assignment to the SPV, the SPV might not be able to enforce it against third parties in the bankruptcy of the originator. The SPV might not be able to enforce it against third parties in the event that the originator sells the receivables (or grants competing security interests) to a third party who does not know of the earlier securitisation assignment and the third party gives notice to the debtor before the SPV does.[154] In addition, debtors without notice can continue to acquire set-off rights and defences that can be exercised against the assignee.[155]

Balance sheet. According to IFRS, the purpose of securitisation may be frustrated if the originator continues to control the SPV. This is because the IFRS

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[150] The Law Commission, Registration of Security Interests, paragraph 6.34.

[151] Generally, see Raines M, Wong G, Aspects of Securitization of Future Cash Flows under English and New York Law, Duke J Comp Int L 12 (2002) p 453.

[152] See, for example, MBNA Europe Bank Ltd v HM Revenue & Customs [2006] EWHC 2326 (Ch).

[153] See The Law Commission, Registration of Security Interests, paragraph 6.36. See also § 409 BGB (Abtretungsanzeige).

[154] See, for example, § 407 BGB (Rechtshandlungen gegenüber dem bisherigen Gläubiger) and § 408 BGB (mehrfache Abtretung). See also Ambery R, Bowmer S, Why Don King Needs a Haircut - Transfer and Assignment of Contracts: How to Sell Trade Receivables under English Law, JIBL 15(9) (2000) pp 216–220.

[155] See, for example, § 406 BGB (Aufrechnung gegenüber dem neuen Gläubiger).

principles take a stricter view on *derecognition* (see section 3.3.2) and *consolidation* compared with the earlier rules.[156]

As the assets are transferred to the SPV, it has to be determined whether the SPV must be consolidated as a subsidiary of the originator. According to IFRS, all "subsidiaries" must be consolidated. A "subsidiary" means an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).[157] The obligation to consolidate the SPV thus depends on the existence of *control*.

"Control" means the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity. However, it can exist even when the parent owns less than half of the voting power.[158] There is a special rule based on the principle of "substance over form" for special purpose entities (SPEs). SPEs should be consolidated where the substance of the relationship indicates that the SPE is controlled by the reporting enterprise. This may arise even where the activities of the SPE are predetermined (the SPE operates on "autopilot").[159]

Credit enhancement. Generally, the SPV will obtain a better credit rating for securities that it will issue if the receivables to be securitised are relatively homogeneous and payments made by the originator's customers are relatively predictable and reliable. In addition, the credit rating can be improved through credit enhancement.

Credit enhancement can take various forms. It can be internal or external. The sources of credit enhancement can be: the SPV; the cash flow; the originator; and third parties such as banks. Covenants are an important component of the credit enhancement package.

Internal credit enhancement. Internal credit enhancement relates to the assets of the SPV.

First, investors will require that their lending to the SPV is adequately secured on the SPV's assets. It is not enough to ring-fence the assets through the separate legal personality of the SPV (see Volume II). The security package may consist of: a security interest in the receivables; any collateral for the receivables themselves (for example, building mortgages); insurances taken out by the SPV; and the SPV's bank account.[160]

Second, the SPV can use over-collateralisation. Over-collateralisation occurs where the pool of assets is of greater value than is needed to support the payments due to the investors. This is designed to help to ensure that if there is a shortfall in

[156] IAS 39 (Financial Instruments: Measurement and Recognition); IAS 27 (Consolidated and Separate Financial Statements); and SIC-12 (Consolidation—Special Purpose Entities).
[157] For key definitions, see IAS 27.4. For German law, see § 290 HGB.
[158] IAS 27.13.
[159] SIC-12.
[160] The Law Commission, Registration of Security Interests, paragraph 6.37.

the cash expected from the revenue-generating assets, there should be surplus funds available within the SPV to cover that shortfall.

Third, the SPV can pay the price of the assets to the originator in tranches (staggered payments). The use of staggered payments can help to mitigate agency problems between the SPV and the originator (for the alignment of interests in general, see Volume I; for credit enhancements in particular, see Volume II).

External credit enhancement. External credit enhancement is based on obligations undertaken by other parties than the SPV.

The originator can be the source of credit enhancement in a number of ways. From the perspective of investors, the originator should provide some credit enhancenemt. If the originator retains little or no risk, the originator has little reason to screen its borrowers and ensure the high quality of the underlying assets. (a) The originator can therefore make a cash payment to the SPV. (b) The bonds can also be issued in tranches. The originator may purchase the junior tranche to reduce the risk for the senior bondholders. Where the junior tranche bears the risk of all the initial losses, the senior tranches are left with a reduced anticipated default rate. (c) The originator might also accept an obligation to buy back bad receivables. On the other hand, such obligations would not be bankruptcy remote (see above).

Banks are a typical source of credit enhancement. For example, the bond issue can be backed by a bank guarantee. Risk is often mitigated through hedging.

Covenants. In a securitisation, one of the main purposes of covenants is to prevent the originator from damaging the revenues on which the success of the securitisation depends. Covenants should therefore be strict enough.

Covenants are necessary also because the originator often acts as the administrator of the receivables that it has sold. As condition of sale, the originator would generally agree: to collect the debts arising under the contracts on the assignee's behalf; not to vary or waive any of the terms of the contracts without the assignee's consent; and not to allow any rights of set-off to arise in the obligor's favour.[161]

However, typical covenants that support securitisations are largely ineffective where the underlying assets fail to generate enough revenue. In such a case, bondholders and noteholders may not be able to exit the investment without suffering serious financial losses.

Securitisation Structures

A securitisation can be structured in various ways. As an alternative to the *standard* asset-backed securitisation, the originator may choose, for example, a *secured loan* structure or a *whole business* securitisation structure. One of the fundamental differences between standard securitisation and secured loan or whole business securitisation relates to the involvement of the originator. Unlike

[161] Ambery R, Bowmer S, Why Don King Needs a Haircut - Transfer and Assignment of Contracts: How to Sell Trade Receivables under English Law, JIBL 15(9) (2000) pp 216–220.

the standard securitisation structure, the latter require permanent managerial involvement on the part of the originator. It is also possible to distinguish between traditional *true sale* securitisation and *synthetic* securitisation.

Example: English football clubs. The choice of the securitisation structure depends on the nature of the firm and its business, among other things. This can be illustrated by the securitisation structures used by English football clubs (Burns 2006).[162] The securitisation model employed by them differs from the standard asset-backed securitisation and can therefore help to understand the factors that influence the choice of the securitisation model in general.

English football clubs have chosen a different securitisation model because of the type of cash flow selected by the clubs to pay off the debt. Clubs do not tend to have a significantly large static asset pool of contractual debts to securitise. Instead, their main source of revenue tends to come from ticket sales. This means that the traditional asset-backed securitisation structure, which tends to be based upon a discrete pool of existing revenue generating assets (for example, contractual obligations), would not be appropriate.

In most football securitisations, the most important selected cash flows are the anticipated future gate receipts, usually supplemented by hospitality income. The utilisation of such cash flows by the club makes sense financially because the long-term future revenues would be helping to pay off the low cost, long-term finance that the club has raised to fund modernisation or expansion of the club's stadium.

The particular models of securitisation that have been selected by the football clubs as being the most appropriate models for utilising anticipated future cash flow are the so-called secured loan securitisation model and the whole business securitisation model.

Secured loan structure. The secured loan structure is typically chosen where a true sale transfer of the revenue generating assets to a SPV would not be possible because of the nature of the cash flow. The lack of a true sale transfer increases risk for investors, unless the cash flows associated with the asset can be effectively ring-fenced from the claims of the originator's other creditors and the asset can effectively be used as collateral.

In a secured loan securitisation, the company that owns the revenue generating asset can create a *subsidiary* to hold title to the asset. The parent then *leases* the revenue generating asset from its subsidiary. The subsidiary pays for the asset that it buys but receives lease payments for its use by the parent. The subsidiary *borrows* the required sum of money for the securitisation from a SPV.

The loan is secured in favour of the SPV. The subsidiary grants security over all its assets. The security is supported by a guarantee from the parent. Also the parent guarantee is secured; for example, shares in the subsidiary company would be used as collateral.

Like in all securitisations, the SPV has been set up to issue bonds or notes in the capital markets. The SPV would grant a security over all its assets in favour of a trustee for the investors.

Whole business securitisation structure. An alternative to the secured loan structure is the whole business securitisation. The whole business securitisation

[162] Burns T, Structured Finance and Football Clubs: An Interim Assessment of the Use of Securitisation, Entertainment and Sports L J, December 2006.

technique uses a variant of the concept of a secured loan rather than a true sale structure. The essential difference between the two models is that in a whole business structure, it is the cash flows from the entire range of operating revenues generated by a whole business, or a segregated part of a larger business, that are securitised. This means that a wider range of assets can be offered to support the securitisation, which in some cases might lead to larger sums being raised. However, this type of deal can also be more costly to establish. There are additional legal costs of setting up the appropriate corporate structures to manage the cash flows and additional costs of arranging the necessary credit enhancements and appropriate covenants to achieve a high credit rating.

The structure of the whole business securitisation is very similar to that of the secured loan. The aim of the structure is to ring-fence the operating cash flows both from the claims of the company's other creditors and from the risk of the company's insolvency.

Typically, the *parent* company incorporates a wholly-owned *subsidiary* to hold all the shares in a *second subsidiary*, which *operates* the business, *owns* the assets, and *borrows* the money from the SPV to pay for those assets. The SPV will also be a wholly-owned subsidiary of the parent and it will act as the issuer of the securities.

The constitutional documents of the SPV will restrict its activities to the activities required by the transaction. The bonds issued by the SPV are enhanced by this corporate group granting the investors security over all of the group's assets. Often the collateral is not given to the SPV directly, but to a security trustee who holds the collateral on trust for the SPV. The SPV will typically give a security over all of its assets to the security trustee, who will hold that collateral on trust for the bondholders. This structure is also likely to be supported by guarantees from the parent and the subsidiary company that acts as a holding company.

For example, Stora Enso, a Finnish-Swedish paper company, carried out a whole-business securitisation transaction on its Finnish forest assets in 2002. Stora Enso transferred its forest assets in Finland into its newly established subsidiary, Tornator Oy, which paid for the assets. A special purpose vehicle was formed (Tornator Finance Plc, a public limited-liability company incorporated in Ireland). The SPV raised €370 million from 45 European investors by issuing secured bonds. The proceeds were used to finance the securitisation transaction. The primary source of funds for servicing interest and repayments of capital falling due to investors was the income generated by the business of the Tornator companies (the income from the sale of felling rights to harvest wood, the provision of forest management services which were offered also to third-party private landowners and the sale of certain selected land areas).

Covenants in secured loan and the whole business organisation securitisation. As can be seen, a key element in both the secured loan and the whole business securitisation structure is the loan agreement between the operating companies and the SPV. The covenants in the loan agreements play a crucial part in helping to mitigate the risk exposure of investors.

Both securitisation structures will require covenants to be undertaken by the parent company, the subsidiary that acts as the operating company, and the subsidiary company that holds title to the revenue generating assets.

Such covenants include financial covenants (for example, undertakings that restrict the level of indebtedness of the group and undertakings that restrict the level of dividend payments by the parent) and operational covenants (for example, undertakings that restrict the business operations of the operating company).

The investors typically want to restrict the level of debt that the group as a whole could incur to a certain fixed percentage of its consolidated income. Investors also want restrictions on the level of dividend payments made by the parent, and a debt service reserve to be created by the asset holding subsidiary company to protect them from payment defaults. Other standard terms would include covenants promising to conduct the business in a proper and efficient manner, and not to make any changes to the nature of the business without the approval of the bondholders. In addition, there is often an obligation to furnish copies of audited accounts and also non-audited quarterly or half-yearly accounts to the trustee for the bondholders.

Synthetic securitisation. In a traditional "real" securitisation, the parties try to achieve a true sale of assets to the SPV and payments to investors depend on the performance of the underlying assets. A synthetic securitisation is different.

A synthetic securitisation provides for at least part of the economic substance of a standard securitisation, but without the actual transfer of any assets. Payments to investors depend on the performance of the underlying assets, but what is transferred is *credit risk* relating to the underlying assets.

A synthetic securitisation means that the owner of assets (the protection buyer) transfers the credit risk of a portfolio of assets (a reference portfolio of reference obligations) to another entity (the protection seller) or directly to the capital markets. Although the credit risk of the reference portfolio is transferred, actual ownership of the reference obligations remains with the protection buyer.[163]

The main objective of a synthetic securitisation is transfer of the originator's credit risk exposure to the capital market. This form of securitisation is almost exclusively used by banks that need to manage their regulatory capital.[164] As there does not have to be any true sale, many of the usual risks can be avoided. Credit risk will be transferred from the originator to the SPV through credit derivatives, in particular through credit default swaps.

The transfer of credit risk may be accomplished in many ways by using credit derivatives or guarantees that serve to hedge the credit risk of the portfolio. The transfer of risk can be funded (for example, through the use of credit-linked notes) or unfunded (for example, through the use of credit default swaps).[165]

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[163] Uwaifo E, Greenberg MI (Sidley Austin Brown & Wood), Key issues in structuring a synthetic securitisation transaction. In: Preston A (ed), Europe Securitisation and Structured Finance Guide 2001, London (2001) p 139–140.

[164] See Kroll MJ, Bürgi JA, Sauter UC, Securitisation in der Schweiz, IFF Forum für Steuerrecht 2002 pp 262–264.

[165] See paragraphs 539 and 540 of the Basel II Accord.

A synthetic securitisation structure is *funded*, if the payment obligation of the risk taker (protection seller) is discharged by the risk taker (protection seller) in full at the start of the transaction, either by the purchase of credit-linked notes issued directly by the risk taker or by providing collateral to secure the risk taker's (protection seller's) obligation under a credit default swap.

A synthetic securitisation structure is *unfunded*, where the risk taker's (protection seller's) obligation is not paid in advance or collaterialised.

A synthetic securitisation structure can also be partially funded, where certain tranches of the credit risk in respect of the reference portfolio are funded and others are unfunded.

The decision whether or not to adopt a funded, unfunded or partially funded structure depends on the objectives of the risk shedder (protection buyer). If the purpose of the synthetic securitisation is to reduce regulatory capital costs, then a funded structure might provide the maximum benefit.

3.4.5 Cash Management

Introduction

Section 3.3 and earlier parts of section 3.4 described ways to turn the firm's assets into cash. This section will discuss the management of cash. The firm can improve its net interest position and reduce its working capital needs through cash management. Typical forms of cash management include *cash pooling* and *netting*. In addition, the Payment Services Directive will enable firms to create so-called "*payment factories*" in the EU.

Cash Pooling

Cash pooling is a form of cash management used by the parent company and its subsidiaries.[166] The firm may prefer to introduce cash pooling for two main reasons. (1) The firm may want to reduce its external financing needs and reduce its balance sheet. Each company in a group usually has its own bank accounts. If the bank accounts of group companies are managed as one net account ("pooled"), the group needs less cash and can decrease its working capital. (2) The second reason is that the firm may want to improve the group's net interest position and pay less for its external funding.

Master account and sub-accounts. The pool typically consists of a master account (the top account, called for example the Group Account) and sub-accounts for each participant. Depending on the form of cash pooling, the top account can

[166] Generally, see Cahn A, Kapitalaufbringung im Cash Pool, ZHR 166 (2002) pp 278–306; Daccò A, Die Zentralisierung des Konzern-Cash-Managements in Italien. Johann Wolfgang Goethe-Universität Frankfurt am Main, Institut für Bankrecht, Arbeitspapiere Nr. 106 (2002); Vandsø Jacobsen S, Lindekilde Schmidt C, Cash Pooling i selskabsretlig belysning, NTS 2002:4 pp 451–465.

be either an actual bank account or a fictive account. Sub-accounts are used for normal cash management transactions and are actual bank accounts.

If the group has a Group Account, all sub-accounts are bank balances on the top account. When funds are paid in or withdrawn from a sub-account, the total available balance on the top account is instantly adjusted.

The top account is normally held by the parent company or a group treasury company (master company). Any number of sub-accounts can be linked to the top account.

Effective cash pooling and fictive cash pooling. There is a distinction between effective cash pooling ("real cash pooling" or cash concentration) and fictive cash pooling (notional pooling).

In effective cash pooling, the firm has one real top account for all participants and each of the participants has its own sub-account. The two main methods of effective cash pooling are Zero Balance Pooling and Single Legal Account. Effective cash pooling can be legally complicated.

In fictive cash pooling, there is a notional top account. Notional pooling is legally less complicated than effective cash pooling.

Single Legal Account. Single Legal Account Pooling is a cash concentration technique based around a single legal master account structure in the name of the parent or group financing company where the other participant accounts act as memo accounts of that legal account.

Zero Balance Account. Zero balancing is a cash concentration technique where all account balances are transferred into a nominated master account. A zero balance account is a bank account that is automatically brought to a zero balance each day.[167] Debits are covered by a transfer of funds from a master account at the same bank. Credit balances are automatically transferred to the master account.

Notional Pooling. Notional pooling is a cash management technique where account balances are offset without physical movement or co-mingling of funds, for the purpose of interest compensation by the bank.

Legal aspects of cash pooling: general remarks. Legal rules that govern cash pooling have only partly been approximated in the EU. For example, effective cash pooling is influenced by company law rules and the Second Company Law Directive. The Payment Services Directive will nevertheless have a major impact on cash pooling (see below).

Cash pooling is always based on a contract between the participating companies and the bank.

Notional pooling is legally less complicated, because it does not result in any intercompany loans. On the other hand, notional pooling raises at least two legal questions. How will the costs and benefits be allocated between the participating companies? Do company law rules (such as the purpose of the company and rules on the distribution of funds to shareholders) prevent a participating company from paying costs, where the benefits are enjoyed by other participating companies?

[167] A Zero Balance Account was applied, for example, in the German case of BGH, judgment of 16.1.2006 - II ZR 75/04 and II ZR 76/04.

Group companies should agree on the distribution of costs and benefits between themselves.

Effective cash pooling (cash concentration) is legally more complicated, because effective cash pooling creates loans and debts between the participating companies. Irreversible donations or distributions of funds might breach company law rules that govern the making of distributions to shareholders.[168]

Particular legal questions. The participating companies must address, for example, the following legal questions.

(a) Will cash pooling be regarded as the pursuit of regulated banking business by the parent? In the EU, cash concentration in the parent's account is not regarded as the pursuit of banking business by the parent[169] and will not require authorisation.[170]

(b) In cross-border cases involving countries that do not belong to the EU, the company should ask whether the transaction is constrained by currency restrictions. In the Member States of the EU, cash pooling between group companies will not be constrained by currency restrictions. Currency restrictions are basically prohibited under the EC Treaty as restrictions on the movement of capital[171] or payment restrictions.[172]

(c) Will the transfer of funds between accounts participating in a cash pool structure be regarded as intercompany lending? To what extent are intercompany loans permitted under company laws? Intercompany lending is usually constrained by company law rules, but it is permitted at least where the transaction is customary and motivated by business reasons.[173] Company laws typically restrict cash pooling where a participating company uses it as a long-term source of funding.[174] A company that acts as a net source of finance for other group companies can be required to charge interest at the market rate.

Under German law, intercompany lending raises particular questions[175] relating to: capital maintenance (upstream loans);[176] equity-replacing loans or shareholder loans[177] (downstream

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[168] Article 15 of Directive 77/91/EEC (Second Company Law Directive).

[169] Articles 1(1) and 4(1) of Directive 2006/48/EC.

[170] See, for example, § 2(1) Nr. 7 and § 2(2) Nr. 5 KWG in German law.

[171] Article 56(1) of the EC Treaty.

[172] Article 56(2) of the EC Treaty.

[173] Vandsø Jacobsen S, Lindekilde Schmidt C, Cash Pooling i selskabsretlig belysning, NTS 2002:4 pp 451–465.

[174] See Blöse J, Cash-Management-Systeme als Problem des Eigenkapitalersatzes, GmbH-Rundschau 14/2002 pp 675–678; Cahn A, Kapitalaufbringung im Cash Pool, ZHR 166 (2002) p 279: "Wenn Liquiditätsanlage und Kreditaufnahme den einzelnen Konzernunternehmen überlassen bleiben, kann ... die Situation eintreten, dass einige Konzernglieder von dritter Seite verhältnismäßig teure Kredite in Anspruch nehmen, während andere Gesellschaften ihre überschüssige Liquidität am Markt anlegen und dafür bestenfalls die übliche Verzinsung erhalten."

[175] Vetter J, Schwandtner C, Cash Pooling Under the Revised German Private Limited Companies Act (GmbHG), German L J 9 (2008).

[176] § 30(1) GmbHG.

[177] § 39(1) number 5 and § 135 InsO (Gesellschafterdarlehen) introduced by the MoMiG.

loans); the causing of insolvency by transferring funds to a shareholder;[178] and the payment of capital increases (see below). Rules on equity-replacing loans ("eigenkapitalersetzes Darlehen") were applied before the entry into force of the MoFiG where the company was in a financial crisis.[179]

(d) How should the participating companies address counterparty credit risk? There is a higher risk that company laws restrict the making of payments to a participating company that is or may become insolvent. This risk can be mitigated by excluding that company from the cash pool (keeping its accounts pool-free). Where a participating company is not yet insolvent, legal risk can be mitigated by agreeing on: effective disclosure duties (participating companies must receive information about the financial status of other participating companies); and early termination rights in the event that there is an increased risk that a participating company will not be able to meet its obligations or will become insolvent. A participating company may require collateral. This would nevertheless make it more difficult to reduce the capital needs of the group. Generally, the company may have a business reason either to require a security or not to require it. A participating company can be asked to agree on the joint and several liability of all participating companies for deficits of the top account.[180] A participating company should in any case ensure that there is a cap on its liability.[181]

(e) How should a participating company take into account company law rules that restrict the distribution of funds to shareholders? Where a participating company's funds are paid in its parent's account, the payment should comply with restrictions on the distribution of funds to shareholders. For example, the Second Company Law Directive prohibits distributions where the net assets of the company are lower than the amount of its subscribed capital.[182] A breach of this rule may result in a duty to return those funds to the company that paid them.[183] Participating companies can mitigate this legal risk generally by agreeing on pool-free accounts for funds that may not be distributed to shareholders. The amount of the subscribed capital should remain pool-free.[184] In addition, this legal risk may be mitigated by ensuring that: the cash pooling transaction is motivated by business reasons; its terms are usual; interest is payable on credit extended by the firm at the market rate; and that payments are not made to shareholders unless they are able to repay their debts when due during the term of the cash pooling.[185]

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[178] § 826 BGB.

[179] § 32a GmbHG (now deleted). The company was in a crisis when: it was not able to borrow funds from third parties at market conditions; it was insolvent; or its debts exceeded its funds (Überschuldung). See Blöse J, Cash-Management-Systeme als Problem des Eigenkapitalersatzes, GmbH-Rundschau 14/2002 pp 675–678; Cahn A, Kapitalaufbringung im Cash Pool, ZHR 166 (2002) p 281.

[180] § 426 BGB.

[181] See Cahn A, Kapitalaufbringung im Cash Pool, ZHR 166 (2002) pp 282–283.

[182] Article 15 of Directive 77/91/EEC (Second Company Law Directive).

[183] Article 16 of Directive 77/91/EEC (Second Company Law Directive).

[184] BGHZ 157, 52 (II ZR 171/01).

[185] RGZ 150, 28; BGHZ 157, 52.

In Germany, the MoMiG made it easier for group companies to grant collateral and use cash pooling.[186]

(f) How should a participating company take into account rules on thin capitalisation and similar rules? (1) In some countries, an insolvency rule can prevent the making of payments (sections 5.3 and 5.4).[187] (2) Under German law, there are restrictions for the protection of the capital of the controlled company. For example, a sole shareholder (Alleingesellschafter) that controls a GmbH (abhängige GmbH) is responsible for the maintenance of the share capital of the GmbH. The sole shareholder is liable for damage caused by breach of duty, where the GmbH cannot fulfil its obligations due to the actions of the sole shareholder (the "Bremer Vulkan" case).[188] There are also other restrictions like rules on shareholder loans (see above).[189] (3) In some countries, loans to a company by its shareholder can, under exceptional circumstances, be regarded as equity that cannot freely be repaid.[190] (4) There can also be the risk of making the master company liable for the debts of the participating companies where the funds of participating companies have not been held separate due to, for example, lack of proper bookkeeping (the doctrine of lifting the corporate veil, the doctrine of Vermögensmischung, or similar doctrines).

(g) How should a participating company take into account insolvency law rules according to which certain payments made before the commencement of the insolvency must be returned to the company?[191]

(h) How should a participating company take into account company law rules that govern share issues or the increase of share capital? In practice, the top account is often in the name of the parent. Where a subsidiary that participates in cash pooling issues shares or increases its share capital, moneys paid by the parent end up in the top account. (1) EU company law can govern this situation in two ways. First, the Second Company Law Directive provides that a company "may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party".[192] On the other hand, a usual cash pool transaction is not done for the purpose of financing the acquisition of shares in the

186 See § 57(1) AktG and § 30(1) GmbHG; Wiehe H, Jordans R, Cash Pooling and Granting Up-stream Security in Acquisition Finance under German Law-Current Situation and Intended Changes, JIBLR 23(7) (2008) pp 351–353; Vetter J, Schwandtner C, Cash Pooling Under the Revised German Private Limited Companies Act (GmbHG), German L J 9 (2008).

187 For US law, see MCBA § 6.40 (c).

188 BGH, judgment of 17.9.2001 - II ZR 178/99 ("Bremer Vulkan").

189 See, for example, § 302(1) AktG; § 19(2) GmbHG; OLG Jena, judgment of 21.09.2004 (8 U 1187/03); BGH, judgment of 10.7.2006 - II ZR 238/ 04.

190 § 39(1) number 5 and § 135 InsO (Gesellschafterdarlehen) introduced by the MoMiG.

191 § 826 BGB; § 64 GmbHG; BGHZ 173, 246; BGH, judgment of 28.4.2008 - II ZR 264/06 (GAMMA); Vetter J, Schwandtner C, Cash Pooling Under the Revised German Private Limited Companies Act (GmbHG), German L J 9 (2008).

192 Article 23(1) of Directive 77/91/EEC (Second Company Law Directive).

company (for financial assistance, see section 20.4).[193] (2) Second, EU company law also regulates the issuing of shares for a consideration other than in cash.[194] The use of the issuing company's net debt as consideration for the shares is in some Member States (like in Germany[195] but not in England) regarded as issuing shares for a consideration other than in cash, meaning that an experts' report becomes necessary under the Second Company Law Directive (see section 5.12).[196] The participating companies can mitigate this legal risk by paying for shares issued by another participating company or the increase in its share capital from pool-free accounts, and ensuring that those payments will be made to a pool-free account. (3) The laws of some countries provide that the increase of share capital cannot be registered unless the funds paid as consideration for shares or the increase of share capital are freely disposable by the company.[197] In Germany, the BGH has, in two cases,[198] held that funds were not freely disposable by the company because of zero balancing. Formally, consideration for the increase of share capital was cash. In reality, however, share capital was increased for a consideration other than cash (verdeckte Sacheinlage). Again, the issuing company can mitigate this risk by ensuring that payments are made to a pool-free account from a pool-free account.

(i) Which accounts and funds should be pool-free? The firm should ensure that there are pool-free accounts for assets that may legally be used only in certain ways. For example, there should be pool-free accounts for external funding that can only be used in certain ways under the firm's contractual covenants and other undertakings. In addition, legal risk can be mitigated if there are pool-free accounts for monies that will be paid as consideration for shares that will be issued by the company or for an increase in share capital.[199] A third example is government subsidies that can only be used for a certain purpose.[200]

Mitigation of risk. The main ways for the firm to mitigate legal risk in a cash concentration (effective or "real" cash pooling transaction) are therefore as follows: a contractual framework that balances the costs and benefits between the bank and the participating companies and between the participating companies; regular disclosure of information to all participating companies; credit limits for

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[193] For a more critical view, see Vandsø Jacobsen S, Lindekilde Schmidt C, Cash Pooling i selskabsretlig belysning, NTS 2002:4 p 458.

[194] Article 27 of Directive 77/91/EEC (Second Company Law Directive).

[195] See also Cahn A, Kapitalaufbringung im Cash Pool, ZHR 166 (2002) pp 283–285.

[196] Articles 10(2) and 10(3) of Directive 77/91/EEC (Second Company Law Directive).

[197] See, for example, § 19(1) GmbHG.

[198] BGH, judgment of 16.1.2006 - II ZR 75/04 and II ZR 76/04; BGH, judgment of 10.7.2006 - II ZR 238/ 04.

[199] For these problems, see Cahn A, Kapitalaufbringung im Cash Pool, ZHR 166 (2002) pp 278–306; Blöse J, Cash-Management-Systeme als Problem des Eigenkapitalersatzes, GmbH-Rundschau 14/2002 pp 675–678.

[200] Cahn A, Kapitalaufbringung im Cash Pool, ZHR 166 (2002) p 283: "Schließlich können Mittel, die einem Konzernunternehmen, von dritter Seite zweckgebunden zur Verfügung gestellt werden, von der Einbringung in den Pool aufgenommen werden, wenn sich die Übertragung auf das Zielkonto mit der Zweckbindung nicht vereinbaren ließe."

all participating companies; avoidance of unlimited joint and several liability for deficits in the top account; early termination rights before the actual insolvency of any participating company; and the use of pool-free accounts.

Contracts between the participating companies. The participating companies should agree on: the internal legal framework in general; the accounts that belong to the pool and pool-free accounts; credit limits, the use of zero balancing or, alternatively, the minimum balance that is pool-free and will not be transferred to the top account; credit terms (interest, collateral, set-off); the division of costs and the fees of the master company; power of attorney for the master company to manage the accounts that belong to the pool; disclosure of information (in particular, information about the financial status of the participating companies); the contract period and rights to terminate the contract; choice of law; and dispute resolution.[201]

Contracts between the bank and the participating companies. The bank and the participating companies should agree on: the consent of the participating companies to the transfer of funds to the top account; interest payable on the balance; collateral; duty to disclose information to the bank; the contract period and rights to terminate the contract; choice of law; and dispute resolution.[202]

The bank's collateral. In effective cash pooling, the bank may need collateral, because the balance on the top account can become negative. It is legally less complicated to furnish the collateral where the top account is in the name of a company that has assets. It can be more complicated to furnish collateral where the top account is in the name of a holding company or a treasury company that does not have assets that can be used as collateral. In that case, the collateral would have to be given by the participating companies. This would again make it necessary to analyse to what extent the giving of collateral complies with company law rules on the distribution of funds to shareholders and other use of company funds.[203]

The duty of care or fiduciary duties of senior executives or the board. The senior executives or the board of a participating company typically owe a duty of care or fiduciary duties to the company (see Chapter 17). These duties are applied generally and therefore even in cash pooling.

In order to comply with their duties in cash pooling, senior executives or the board of each participating company should focus on three areas in particular: (1) the balance of costs and benefits (terms, risks, collateral); (2) the creditworthiness of other participating companies, other participating companies' duties of disclosure, collateral received by the company, the right to terminate the agreement in the event of material adverse change of the creditworthiness of a participating company, credit limits; and (3) termination of the agreement in the event of material adverse change.[204]

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[201] Karollus M, Rechtsfragen des Cash Pooling (2003).
[202] *Ibid.*
[203] *Ibid.*
[204] *Ibid.*

Netting

Netting is a further form of cash management (for the legal aspects of netting and set-off, see also Volume II). A group of companies can rationalise its production on a global basis. This involves highly coordinated physical flows of material, parts, and finished products. Physical flows are accompanied by a heavy volume of intercompany fund flows. The firm can reduce costs by minimising the total volume of intercorporate fund flows. This can be achieved by payments netting.[205] Like cash pooling, the use of netting may reduce the group's working capital needs.

Without netting, the group tends to make a large number of intra-group payments and payments between group companies and external business partners. With netting, payment flows are reduced as only net amounts are settled with each participant.

Netting can be bilateral or multilateral. Bilateral netting can be used between two parties. However, bilateral netting would be of little use where there is a complex structure of internal sales. For example, bilateral netting is of no use if subsidiary A sells €1 million worth of goods to subsidiary B which in turn sells €1 million worth of goods to subsidiary C while C has €1 million in sales to A. On a multilateral basis, however, total transfers would net out to zero.[206]

Definition. In Community law, netting has been defined as "the conversion into one net claim or one net obligation of claims and obligations resulting from transfer orders which a participant or participants either issue to, or receive from, one or more other participants with the result that only a net claim can be demanded or a net obligation be owed".[207]

Netting center, central counterparty and settlement account. Netting requires a settlement *account*.[208] Netting also requires a netting *center* that consists of one or more entities. Somebody – that is, the netting center – must coordinate information flows to and from the participating companies (collect information about payments from the companies and pass information about netting to them), calculate the net positions of the participating companies,[209] act as the central counterparty,[210] and act as a clearing-house for payments.[211] There can also be other parties such as a party extending credit to the participating companies.[212]

The netting cycle. The netting procedure follows a pre-defined schedule. One can distinguish between the information day, the confirmation day, the business day, the settlement day, and the third party day. The participating companies send information about their payables or receivables to the netting centre on the infor-

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[205] Shapiro AC, Payments Netting in International Cash Management, J Int Bus Studies 9(2) (1978) p 51.

[206] *Ibid*, pp 51–52.

[207] Article 2(k) of Directive 98/26/EC (Settlement Finality Directive).

[208] For the definition of "settlement account", see Article 2(l) of Directive 98/26/EC.

[209] For the definition of "clearing house", see Article 2(e) of Directive 98/26/EC.

[210] For the definition of "central counterparty", see Article 2(c) of Directive 98/26/EC.

[211] For the definition of "clearing house", see Article 2(e) of Directive 98/26/EC.

[212] For the definition of "settlement agent", see Article 2(d) of Directive 98/26/EC.

mation day, after which the netting center performs preliminary netting and transmits the results to the participating companies for review. On the confirmation day, the participants receive information about their preliminary net positions. The netting center then makes adjustments as advised by the participating companies. On the business day, each participating company gives payment instructions to its bank, and the netting centre performs the currency conversions and runs the final netting. On the settlement date, each of the participating companies' banks effects transfers for the net amount owed to the netting center, which acts as a clearinghouse for the settlement on same day. The settlement day is therefore the value date of all internal netting payments paid/received by participants on a same-day value basis. The third party day is the value date for third party transactions.

Community law. Insolvency laws and Member States' traditional set-off rules have created legal risks that influence the finality of payment netting and the validity of collateral security provided in connection with participation in payment netting. The availability of a set-off under the applicable national insolvency law is important if it turns out that the assets of the debtor are insufficient to satisfy all claims. However, there are differences in the national insolvency laws regarding set-off.[213] Because of national insolvency laws and traditional provisions on set-off, the netting of payments has not always been legally enforceable and binding on third parties. The commencement of insolvency proceedings may have a retroactive effect on the rights and obligations of participants in a netting system.

Legal risks relating to the finality of payment netting may give rise to concern as to how the level of exposure of a participant (a participating company or a bank) to a particular counterparty should be calculated. Is the party entitled to measure its exposure by reference to the net position, so that it may assume that, in a liquidation of the counterparty, the rights and obligations under the various contracts between them will be set against each other so as to produce a balance? Or should the party look instead to the gross position, whereby it may have to perform the unprofitable contracts and only receive a dividend on the contracts that otherwise would have been profitable from its point of view (the problem of "cherry-picking" and the Herstatt risk)?[214]

Problems relating to the finality of payment netting can give rise to a systemic risk in capital markets. Community law has addressed this risk. The purpose of the Settlement Finality Directive adopted in May 1998 was to reduce the systemic risk

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[213] In *Germany*, the Insolvency Code (Insolvenzordnung, InsO) provides that the insolvency creditors' right to set-off is not affected by the filing or the petition or by the court's order of commencement (§ 94 InsO). However, set-off requires that the debts are due (§ 95(1) InsO). In addition, set-off is not permissible (1) if the creditor becomes a debtor of the estate only after proceedings have commenced, (2) if the creditor acquires its claim from another creditor after proceedings have commenced, or (3) if it acquires the right of setoff by means of a voidable transaction (§ 96(1) InsO). See also § 20(1) of the Austrian Bankruptcy Code (Konkursordnung, KO). In *England*, Rule 4.90 of the Insolvency Rules 1986 provides that set-off of mutual debts is mandatory in all liquidations and cannot be excluded by agreement between the parties.

[214] See Derham SR, Set Off and Netting of Foreign Exchange Contracts in the Liquidation of a Counterparty: Part 1, JBL 1991 p 463.

associated with participation in payment and securities settlement systems, and in particular the risk linked to the insolvency of a participant in such a system.

The Directive applies to payment and securities settlement systems as well as any participant in such a system, and to collateral security provided in connection with the participation in a system. According to the main rule, payment netting shall be final: "No law, regulation, rule or practice on the setting aside of contracts and transactions concluded before the moment of opening of insolvency proceedings ... shall lead to the unwinding of a netting."[215]

Payment netting shall be legally enforceable even in the insolvency of a participant, provided that "transfer orders were entered into a system before the moment of opening of such insolvency proceedings" or "the settlement agent, the central counterparty or the clearing house can prove that they were not aware, nor should have been aware, of the opening of such proceedings".[216]

Furthermore, "insolvency proceedings shall not have retroactive effects on the rights and obligations of a participant arising from, or in connection with, its participation in a system earlier than the moment of opening of such proceedings".[217]

However, the Directive does not require the inserting of a netting clause into any contract. Typically, no netting will take place unless netting is based on a prior contract term.

SEPA and the Payment Factory

In addition to cash pooling and netting, the firm may use what is known as a "payment factory". To what extent such a "factory" can be used depends on the available payment systems.

Payment systems facilitate the purchase of goods and services. Cross-border payments have traditionally been expensive, because payment systems have been nationally based and fragmented. Firms have suffered from this fragmentation in even other ways. They have been unable to integrate their invoicing with their payments. In order to reduce costs, firms that regularly buy or sell cross-border have often had to set up bank accounts in the different euro area countries where they do business, but this has lead to new costs and contributed to payment delays and general inefficiency.

SEPA and PSD. Community law has addressed this problem. The purpose of the Single Euro Payments Area (SEPA) and the Payment Services Directive (PSD) is to create an integrated payment system for the euro area.

The Single Euro Payments Area (SEPA) is an initiative of the European banking industry that will make electronic payments across the euro area as easy as domestic payments within one country are. The legal framework for SEPA is provided by the Payment Services Directive (PSD), which was adopted in April

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[215] Article 3(2) of Directive 98/26/EC (Settlement Finality Directive).
[216] Article 3(1) of Directive 98/26/EC (Settlement Finality Directive).
[217] Article 7 of Directive 98/26/EC (Settlement Finality Directive).

2007.[218] The Member States must transpose the Directive into national law by 1 November 2009.

SEPA and the PSD are expected to bring many benefits. At a general level, opening up national payment markets for new providers and ensuring a level playing field is expected to increase competition and foster cross-border provision of services. What is most important for firms is that business customers and consumers will be able to reach all accounts SEPA-wide from one home country account. The Directive thus enables the firm to improve its cash management.

Fewer bank accounts. A company will basically need only one bank account for incoming payments from the whole euro area. For example, businesses can set up cross-border direct debits in euro and bill customers regularly on a cross-border basis. With SEPA, a company can organise all its euro payments from a single euro account in the country of the firm's choice.

Payment factory. In the past, companies have used different systems to run different payment methods with country-specific formats. This has made it difficult to achieve a high degree of automation and economies of scale. The PSD and SEP enable the firm to manage its payment transactions on a centralised basis. The firm can use one channel for payment transactions and to generate all payment instructions in standard formats. In short, it is easier for the firm to use a "payment factory".

A "payment factory" consists of centralised management of payment transactions, liquidity, and cash pooling. It is based on internal standardisation. A bank will then arrange payments on the firm's behalf. The PSD and SEP make the creation and operation of payment factories easier by helping the firm to reduce the number of bank accounts and banks in the euro area and by making the use of e-invoicing easier.[219]

Electronic invoicing. Community law facilitates the use of e-invoicing in several other ways.

The Electronic Commerce Directive (ECD) generally provides that electronic invoicing must be as valid as paper invoicing. The ECD requires Member States to "ensure that their legal system allows contracts to be concluded by electronic means". In addition, "Member States shall in particular ensure that the legal requirements applicable to the contractual process neither create obstacles for the use of electronic contracts nor result in such contracts being deprived of legal effectiveness and validity on account of their having been made by electronic means".[220]

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[218] Prior legal acts adopted by Community institutions in this area include: Recommendation 97/489/EC providing for the protection of customers using electronic payment verification instruments, such as payment cards; Directive 97/5/EC facilitating cross-border credit transfers in establishing common customers' protection requirements; and Regulation 2560/2001 on cross-border payments that eliminated the difference of price between cross-border and national payments.

[219] See, for example, Fehr B, Zahlungsverkehr im Umbruch, FAZ, 30 January 2007.

[220] Article 9 of Directive 2000/31/EC (ECD).

The E-invoice Directive[221] addresses questions relating to VAT and various other questions. The E-invoice Directive imposes on the Member States the obligation to set up a framework permitting the use of e-invoices without any prior authorisation. However, e-invoices can only be used when the other party accepts the principle of using e-invoices.

3.5 Excursion: Basel II

The Basel II framework describes a standard for capital adequacy applicable to internationally active banks (for the Basel II framework, see also Volume I). Although this book's purpose is limited to non-financial firms, some remarks can be made, because the capital requirements of financial institutions can influence the availability and cost of debt funding.

Capital Requirements Directive. In the EU, the Capital Requirements Directive reflects the Basel II standards but has a wider scope. The Capital Requirements Directive is basically applied to all credit institutions[222] and to investment firms.[223] According to the Directive, financial institutions must ensure that they "have internal capital which, having regard to the risks to which they are or might be exposed, is adequate in quantity, quality and distribution".[224]

Risk exposure. The risk exposure on the basis of which capital requirements are determined includes, in particular, credit risk, operational risk, and market risk.

Risk-weighted assets. According to the Basel II Accord, total risk-weighted assets are determined by multiplying the capital requirements for market risk and operational risk by 12.5 (that is, the reciprocal of the minimum capital ratio of 8%) and adding the resulting figures to the sum of risk-weighted assets for credit risk.

The Basel Committee on Banking Supervision applies a scaling factor to the risk-weighted asset amounts for credit risk assessed under the IRB approach. The purpose of the scaling factor is to "broadly maintain the aggregate level of minimum capital requirements, while also providing incentives to adopt the more advanced risk-sensitive approaches of the Framework".[225]

Credit risk. There are thus alternative approaches to the calculation of minimum capital requirements for credit risk. Financial institutions may choose the Standardised Approach, the Foundation IRB (Internal Ratings Based) Approach, or the Advanced IRB Approach.

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[221] Directive 2001/115/EC amending Directive 77/388/EEC with a view to simplifying, modernising and harmonising the conditions laid down for invoicing in respect of value added tax.

[222] Recitals 5 and 6 of Directive 2006/48/EC. For the scope of the Directive, see Articles 1 and 2.

[223] Articles 1(1) and 2 of Directive 2006/49/EC. See also recitals 11 and 28 of Directive 2006/49/EC.

[224] See recital 29 of Directive 2006/49/EC.

[225] Paragraph 44 of the Basel II Accord. For transitional arrangements, see paragraphs 45–49.

The Standardised Approach is straightforward to use and does not require institutions to provide their own estimates of risks, because it permits the use of external ratings of rating agencies and export credit agencies. It also permits the recognition of a wide range of risk mitigants such as collateral and guarantees.

The Internal Ratings Based (IRB) Approach allows institutions to provide their own risk inputs (such as probability of default and loss estimates) in the calculation of capital requirements.[226]

Operational risk. Operational risk is the risk that financial institutions suffer losses due to problems with their systems or processes, or due to human error, or as a result of external events. Three methods of calculating the capital requirements for such risks are available. They include the very simple method based on a percentage of total gross income, an intermediate approach which requires activities to be ascribed to eight different business lines, and an advanced approach which relies on institutions' own calculations of operational risk.[227]

Certain investment firms are permitted to continue to use the "expenditure-based capital requirement" instead of the specific operational risk requirement. This applies to investment firms which do not, as a central activity, undertake the activities of dealing in securities on their own account or underwriting the issue of securities.

Market risk. Market risk is the risk of losses because the market value of a financial institution's assets, liabilities and off-balance sheet items varies with changes in market conditions. Market risk includes interest rate risk, currency risk and equity market risk.

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[226] See paragraph 444 of the Basel II Accord. See also BIS, Basel Committee on Banking Supervision, Principles for sound stress testing practices and supervision (May 2009).

[227] Paragraph 645 of the Basel II Accord.

4 Debt

4.1 Introduction

All firms lend and borrow. For example, the firm is a lender if it has a bank account in credit, and a borrower if its bank account is overdrawn. The firm is a creditor if buyers pay for the firm's products after delivery, and a debtor if it uses trade credit as a source of funding. Banks base their business on lending, borrowing, and buying and selling debt. Typically, most of the debt finance for small and medium-sized enterprises is provided by the banking sector. Firms might borrow to finance business expansion, meet day-to-day expenses, or to ease short-term cash flow problems.

Advantages and disadvantages of debt. The use of debt can bring the borrower many benefits: (a) In perfect capital markets, debt would be cheaper than shareholders' capital, because debts must be repaid. (b) Debt is flexible. The firm can usually repay the debt when it no longer needs the funds. (c) The cost of the borrowing might be tax deductible. (d) Debt belongs to traditional corporate governance tools, because it gives the firm an incentive to be effective. In addition, debt does not dilute existing share ownership. (e) In addition, return can be increased by gearing.

On the other hand, there may be some drawbacks: (a) Debt appears on the balance sheet, and too much debt will have an adverse effect on the firm's debt-to-equity ratio. (b) A very high gearing increases the risk of business failure and can make it more difficult for the firm to survive in the long term.[1] (c) Generally, a higher gearing and a higher debt-to-equity ratio can: signal an increase in credit risk for banks, suppliers, and other providers of debt; lead to a lower credit rating; decrease the availability of debt; and increase its cost. (d) Although debt can be flexible, the formal and de facto powers of lenders may restrict managerial freedom and prevent the firm from taking important business decisions without creditors' consent.

Types of debt. The firm can borrow money in various ways. (a) It can borrow money from banks and other financial institutions under loan facilities. There are various kinds of loan facilities and loan instruments. The terms of bank lending

[1] The fate of Long-Term Capital Management is an example of the effect of very high gearing on potential return and risk. Lowenstein R, When Genius Failed. The Rise and Fall of Long-Term Capital Management. Fourth Estate, London (2001): "For four years, the brain trust in Greenwich had made money faster than anyone else. Now, like a movie that reveals an unsuspected horror on rewind, they were losing it incomparably faster."

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
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are usually dictated by the bank. (b) Sometimes the firm can borrow from other non-financial firms. For example, the firm's suppliers can extend credit in order to further sales (see section 3.4.2). In this case, the firm may be able to negotiate the terms of the borrowing. (c) If the firm is large enough, it can also turn to the market and issue debt securities. In this case, the firm may be able to dictate its own terms. On the other hand, the firm will not be able to raise any money, unless potential subscribers of debt instruments find those instruments commercially attractive. (d) A debt instrument can be complemented by credit enhancements (Volume II). (e) The firm can choose the seniority of the debt instruments that it issues by a combination of maturity (long or short), repayment schedule (regular repayments or bullet), and subordination (debt, collateral, corporate structure), and by using the equity technique in general (for the equity technique, see section 5.1).

Trade debts. Trade debts are an important source of funding.[2] Trade debts were already discussed in the context of accounts receivable and accounts payable (section 3.4.2).

The firm usually does not pay interest on trade debts that it pays on time. In addition, the seller can sometimes grant a discount for prompt payment.

Trade debts can be a particularly important source of funding for powerful buyers that can force their suppliers to extend interest-free credit. Ruthless buyers sometimes try to force suppliers to grant further discounts by claiming that the goods do not conform to the contract (and are thus not what the supplier promised).

The role of trade debts depends on, among other things: the nature of the transaction; the country; and the parties. Sellers are more likely to extend credit if the transaction is a simple sale of goods transaction (say, oranges) and less likely to extend credit if the product is expensive and tailor-made for the buyer (e.g. a ship). The buyer's country of origin plays a role. Because of a lower country risk and a different payment culture in Finland, a Finnish buyer is more likely to obtain credit than, say, a Nigerian buyer would be. The identity of the parties is important. For example, it is easier for the seller to extend credit in the context of an established business relationship, because the seller has already had an opportunity to verify such information about the quality of the customer's payment behaviour that cannot be verified in advance.

Loan facilities. Commercial lending by banks can take various forms.[3] The generic term "facility" is often used to describe them all and the terms loan facility and loan agreement tend to be interchangeable.

In principle, however, a distinction could be made between a *loan facility agreement* and a *loan agreement*. The term facility reflects the fact that the lender

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2 Rajan and Zingales report that accounts payable for large firms equal to 15% of assets in the US, 11.5% in Germany, and 17% in France. Rajan RG, Zingales L, What Do We Know about Capital Structure? Some Evidence From International Data, J Fin 50 (1995) pp 1421–1460. See also Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 82.

3 See Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006) paragraphs 2.4–2.6; Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) pp 299–300.

makes a loan available to the borrower subject to certain conditions. The borrower might not have any obligation to borrow. Under a loan agreement, however, the borrower has agreed to borrow money, and is obliged to draw down.[4]

Loan facilities can be with one bank or made available by a group of banks (a syndicate; for *syndicated loans*, see section 4.7 and Volume II).

The most basic loan facility is the "*term loan*". Term loans vary from the short term (bridging finance, working capital, trade finance) through the medium term (two to five years for working capital, some capital expenditure) to the long term (project finance, capital expenditure). Term loan facilities provide that a bank is committed throughout a specified period (the commitment period) to make advances upon request by the firm up to a maximum amount, with all the advances being repayable together. A term loan can have a fixed repayment schedule with a specified maturity date and the advances repayable either in instalments or in one lump sum (bullet repayment). Alternatively, the firm can borrow for a selection of periods, repay and borrow again (a revolving loan). The facility may be available in a single currency or in a selection of currencies with an ability to switch from one to another (a multi-currency option).

The facility can be an advance facility or a bill or acceptance facility. An *advance* facility is a facility where the banks make cash advances to the borrower. A *bill or acceptance* facility involves the drawing of bills of exchange on the banks.[5]

The firm can borrow either at *interest* or at a *discount* or *premium*.

There can be distinctions based on the *maturity* of the loan facility. A swingline facility is a committed facility providing for very short-term advances (typically up to seven days), and is generally put in place to support a commercial paper programme.

The purpose of a swingline facility is twofold (Fuller): "First, if the firm has to repay a tranche of commercial paper and does not want to issue a new tranche on the repayment date because of what it sees as temporarily adverse market conditions, it can repay through the use of the swingline facility and issue the commercial paper (and thereby repay the swingline advance) a few days after. Second, it reassures potential purchasers under the commercial paper programme that the company will be able to repay them on maturity regardless of market conditions."[6]

Loan instruments. It can be seen that there is a wide range of loan instruments. For example, the firm can turn to a bank and agree on a facility. A medium-sized firm can raise short-term debt in the domestic money markets. A large firm can issue commercial bills or commercial paper. A large firm can also issue debt securities such as corporate bonds into the domestic primary market, or into the international market.

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4 Adams D, Corporate Finance: Banking and Capital Markets. LPC 2003/04. Jordans, Bristol (2004) p 39.

5 Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006) paragraph 2.5.

6 *Ibid*, paragraph 2.6.

From a legal perspective, loan instruments can be "negotiable instruments" and regarded as "Wertpapiere", or receivables that are neither "negotiable" nor "Wertpapiere" (see Volume II).

Loan instruments can differ in terms of *seniority*. The Economist described the wide range of loans instruments as follows: "With the new investors has come a bewildering variety of loans. Instead of a short chain – secured creditors, unsecured creditors and shareholders – now there are senior or first-lien creditors (who have first dibs on a company's assets), second-lien creditors (who also have claims over the assets of a company, but who get paid only after first-lien creditors), mezzanine creditors, senior subordinated debt holders and subordinated debt holders. At the bottom of this caste system, as before, are the shareholders, who get any leftovers."[7]

Some loan instruments are asset-backed. For example, the "conduits" (special purpose vehicles) that invested in US subprime mortgages before the financial market crisis that began in mid-2007 issued various kinds of asset-backed loan instruments: Asset Backed Commercial Paper (ABCP); Credit Linked Notes (CLN); and Asset Backed Securities (ABS). Typical loan instruments that were issued by those conduits but were not asset-backed contained Commercial Paper (CP) and Medium Term Notes (MTN).

There are *convertible* loans and loans that are not convertible. There are also other distinctions. For a taxonomy of payment obligations, see Volume II.

Nature of loan agreements. An intertemporal value transfer is characteristic of all loan transactions, and loan transactions are characterised by performances that are separated by a relatively long period of time.[8]

Loan transactions can thus be contrasted with many predominately non-financial transactions between two contract parties in which there is no intertemporal value transfer. The two parties structure their agreement so that each party has to perform all or part of its obligations at about the same time that the other party has to perform its obligations. For example, in a purchase and sale contract, the buyer will have to pay the seller or make arrangements for it to be paid at more or less the same time that the seller ships the goods to the buyer.

The separation in time of the performances of the two parties influences both the underlying logic of a loan transaction and the dynamics of the negotiations between the borrower and the lender.[9] First, the borrower might refuse to repay the loan when it falls due. The lender must therefore manage credit risk. Second, the lender counts on the borrower performing its obligations in a timely manner so that the lender will be able to repay its own obligations when they fall due. The lender will therefore have to manage refinancing risk.

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[7] The walking dead, The Economist, December 2007.

[8] Bradlow DD, Some lessons about the negotiating dynamics in international debt transactions. In: UNITAR, Problems and Perspectives of Debt Negotiations, DFM Document Series, Document No 9, Geneva (April 2000).

[9] *Ibid*.

IFRS. Accounting for loan relationships is important not only for lenders but also for debtors. Accounting standards set out when lenders may record loan assets at market value and when they must write down the asset. If the asset is written down, the lender will incur a loss. This will signal poor credit quality to other existing or potential lenders and, as the lender already has incurred a loss, make the lender less friendly.

Accounting for loans can fall within the scope of IFRS (IAS 39). Initially, financial assets and liabilities should be measured at fair value (including transaction costs, for assets and liabilities not measured at fair value through profit or loss). Subsequently, financial assets and liabilities should be measured at fair value. There are some exceptions. For example, loans and receivables, held-to-maturity investments, and non-derivative financial liabilities should be measured at amortised cost using the effective interest method (IAS 39.46). This means that IAS 39 recognises two classes of financial liabilities: financial liabilities at fair value through profit or loss; and other financial liabilities measured at amortised cost (IAS 39.47). The entity can use a fair value option subject to certain conditions (IAS 39.9).

Accounting for loan loss can contain judgmental areas. The most judgmental area in loan loss allowance determination is when to establish that a loss has been incurred and how to estimate these losses, before the loss event has become specifically identifiable.

According to IFRS, a financial asset is impaired, and impairment losses are recognised, only if there is objective evidence as a result of one or more events that occurred after the initial recognition of the asset (IAS 39.58). Under IFRS, allowances can thus be established for objectively verifiable incurred loss events. In the amendments of IAS 39, the IASB has concluded that it is possible to accept loan loss allowances for incurred but not yet identified loan loss.

There can be differences in the application of US GAAP and IFRS with respect to determining loan loss allowances. In practice, however, the principles regarding the accounting for loan loss allowances under US GAAP and IFRS are essentially converged and the allowance for loan losses should, in principle, be the same.

4.2 Management of Risk: General Remarks

The borrower will manage the risk exposure of lenders. For example, factors that signal a lower risk to lenders might include: a long history without defaults (this can signal that the borrower knows how to avoid credit default even in the future); unrestricted assignability (making exit easier); a large and diversified investor base (this can signal that the debt securities are liquid, that their market valuation is reliable, that there is easier exit, and that the risk of market collapse is lower); a dense distribution of maturities (this can signal that the borrower will be able to pay when securities fall due); and the existence of credit enhancements (Volume II).

The borrower will also manage its own risk exposure. For the borrower, loan facility agreements can give rise to the same risks as contracts (see Volume II) or funding contracts (section 2.4) in general. In addition, some risks are characteristic of loan facility agreements in particular.

Risks inherent in the statements of the parties (drafting risk). International loan agreements generally tend to be longer than international agreements for the sale and purchase of goods and services. Loan agreements define the rights and obligations of the parties and the allocation of risk in a comprehensive manner. For this reason, the firm must pay close attention to drafting (for the flexibility of contracts risk, see Volume II).

The four basic steps for drafting a loan agreement nevertheless are the same as when drafting contracts in general: (1) initial understanding of the nature of the transaction and its legal framework; (2) review of existing agreements with the same party and other parties; (3) understanding of the core commercial terms of the agreement; (4) drafting clauses of the loan agreement.[10]

Legal framework, standardisation, tradeability. The legal framework is typically in standard form. It can be based on pre-formulated contract terms or a legal platform (see Volume II).

The advantage of standardisation to lenders is that the terms and conditions which are of common nature need not be repeated or specified in every loan agreement. The individually negotiated terms can therefore be short.

For example, the World Bank group lending institutions follow the system of dividing a loan agreement into two parts. The first part is General Conditions Applicable to Loan and Guarantee Agreements and the second part consists of specific terms of a particular loan agreement.

The advantage of standardisation to borrowers is that they know what kinds of clauses to expect. The disadvantage of standardisation to borrowers is that once the terms and conditions of lending are standardised, they can become non-negotiable. The lending institutions typically do not allow any change in the standardised conditions on the pretext that if they allow negotiation and consequential changes in the standardised terms and conditions in one case, other borrowers ask for negotiations and changes in other cases as well.[11]

The legal framework can also be based on a legal platform shared by many parties. The use of a legal platform can reduce transaction costs for all parties.

For example, the more widespread use of standard loan agreements published by the London-based Loan Market Association (LMA)[12] could reduce transaction costs in international transactions. The LMA standard agreements are intended to provide banks and borrowers with a common template as a basis for negotiations, to make the documentation

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[10] Agarwal VK, Best Practices in Drafting Techniques of a Loan Agreement, UNITAR Best Practices Series in External Debt Management No 3 (2002) p 7.

[11] *Ibid*, p 11.

[12] The LMA was formed in December 1996 with the objective of encouraging the development of the secondary loan market in Europe. The primary objectives were to bring greater clarity, efficiency and liquidity to the then fledgling secondary market by introducing recommended forms of documentation and establishing sound, widely accepted market practices.

process more efficient and allow negotiations to begin from a more reasonable starting point as the form of the more basic provisions has been settled.[13]

The use of a legal platform or a high degree of standardisation can increase the tradeability of loans in the secondary market, reduce the lender's risk exposure, and reduce the borrower's funding costs. It would be difficult and expensive to trade loans in the secondary market without standardisation, because an agreement may contain several different facilities, options, and complex covenants and agreements running in different directions - from the borrower to the lender, from the lender to the borrower, and, in syndicated loans, from the lender in favour of other lenders and the agent bank.

Review of existing agreements. The review of existing agreements is necessary in particular to reduce the risk of default or the occurrence of a termination event under existing and future agreements (for example, pari passu clauses, negative pledge clauses, other covenants, and material adverse change clauses), and liquidity risks caused by the timing of payments under different agreements.

Lender's discretion v borrower's managerial discretion. Generally, loan agreements often give the lender plenty of discretion. For example, the agreement may give the lender an absolute discretion to assign the loan amount.

The lender will try to ensure that the borrower is not permitted to undertake any activity that may make it unable to perform its obligations. The lender might also try to ensure that the borrower is bound by the agreement during the whole term of the agreement and will not prepay the funds in advance.

While the lender may prefer to mitigate risk by constraints on managerial discretion, the borrower usually tries to lift those constraints or restrict the exercise of the lender's discretion by diluting or qualifying the lender's rights.

The borrower tries to achieve the greatest possible freedom in how it conducts its business and uses moneys that it has received from the lender. One of the borrower's basic objectives when drafting the loan agreement is to maximise its freedom of action during the course of the loan transaction by limiting the scope of each restrictive covenant and representation and warranty as much as possible. [14] Another is the freedom to prepay the funds in advance.

If the covenants, representations and warranties, and clauses on prepayment are too restrictive and leave the borrower too little managerial discretion, the borrower will be exposed to a higher commercial risk. Restrictions on prepayment contribute to interest rate risk. Too restrictive representations and warranties, covenants, and events of default are likely to increase the risk of default.

Need to raise additional funding. The problem with the lenders having plenty of discretion and the borrower having too little discretion can materialise, for example, when the borrower needs more money and must raise additional funding.

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[13] See, for example, Gayle C, Acquisition Finance – Syndication Best Practice, Int Comp Comm L R 13(8) (2002) p 305.

[14] Bradlow DD, Some lessons about the negotiating dynamics in international debt transactions. In: UNITAR, Problems and Perspectives of Debt Negotiations, DFM Document Series, Document No 9, Geneva (April 2000).

The borrower's investment project might include an estimate of capital cost. However, the firm might incur large additional capital cost. If that cost has not been included in the original finance plan for the project, the firm might not have any immediate funds available to pay for it. The question arises how that additional capital cost can be funded.

The firm would normally deal with additional capital costs by raising additional funding. Raising new funding may nevertheless face various difficulties. First, existing lenders might not be willing to provide any additional funding. Second, they might also not be willing to allow new lenders to do so. If the raising of new funding requires lender approval, existing lenders have plenty of bargaining power. This would put the firm at a disadvantage in negotiations with the lenders.[15]

Interest rate risk. Interest rates may change. The borrower can mitigate interest rate risk through: fixed or variable interest rates; prepayment options; and the length of the interest period.

When interest rates rise, the firm may benefit from a fixed interest rate or a prepayment option. When interest rates fall, the firm may benefit from a variable interest rate.

This can be illustrated by consumer mortgages. (a) Danish consumer mortgages typically provide for the combination of fixed interest rates and an option to repay the loan early. Danish mortgages thus shield borrowers from interest-rate risks. If rates rise after they buy a home, they are protected by the fixed interest rate. If rates fall, they can take out a new mortgage at a lower rate and prepay the old one. The prepayment option, like bond issuers' options to call some bonds before they mature, transfers interest rate risk to the lender.[16] (b) In the US, mortgage rates are usually fixed, but borrowers can remortgage easily when rates drop. (c) In England, however, mortgage rates are usually variable and borrowers face the risk of rising interest rates. If the mortgage rate is fixed, the borrower must often pay hefty fees to get out of the contract.

In so-called Eurocurrency lending,[17] one of the basic assumptions is that each bank will fund its loan to the borrower by taking a deposit from another financial institution in the same amount as the funds advanced to the borrower (matched funding). Because it is difficult for banks to obtain deposits in the interbank market for periods of more than 12 months, most Eurocurrency loans are broken into interest periods of a shorter duration, and banks take matching deposits only for each interest period as it begins. The result is that the interbank reference rate will change for each successive interest period as it begins. In addition, the lender wants any increased costs (such as withholding taxes or unexpected reserve re-

[15] Yescombe ER, Principles of Project Finance. Academic Press, San Diego London (2002) § 10.6.1.

[16] A Danish model in Aztec dress, The Economist, January 2007.

[17] Eurocurrency is the term used to describe loans or deposits residing in banks that are located outside the borders of the country that issues the currency the loan or deposit is denominated in. For example, a deposit denominated in US dollars residing in a Japanese bank is a Eurocurrency deposit (a Eurodollar deposit).

quirements) to be shouldered by the borrower (increased costs clause, see the following section).[18]

The parties may agree that the borrower has some discretion to choose the length of each interest period during the term of the agreement.[19] For example, the borrower will choose a short interest period if the borrower believes that interest rates will fall, and a long interest period if the borrower believes that interest rates will rise.[20]

Representations, warranties, covenants, events of default. In a loan facility agreement, the purpose of representations, warranties, and covenants is not to just to form a basis for the pricing of the facility but also to allocate risk for particular events. A misrepresentation typically entitles the lender to cease making further advances and/or triggers an event of default.[21]

Events of default are primarily designed to permit the lender (or, in syndicated loans, the agent on instruction of the majority banks) to accelerate outstanding debt and/or to enforce security prior to scheduled maturities. Furthermore, they are designed to allow the lender (or, in syndicated loans, the agent) to place loans on demand, cancel commitments, suspend further drawdowns and require cash cover for letters of credit or other contingent liabilities of the lender (or the syndicate banks). [22]

Risk of default. In any agreement, breach of contractual obligations will trigger remedies (representations and warranties are thus connected with imdemnities). In a loan facility agreement, however, remedies are typically triggered by events of default which have been defined in the agreement (representations and warranties are thus connected with events of default and events of default are connected with imdemnities). The risk of default depends on the terms of the contract, in particular on the definition of events of default (probability) and the remedies available to the lender in the event of default (impact).

There are usually two kinds of events of default. Actual *breach* of any of the obligations under the loan agreement typically constitutes an event of default. The others are *anticipatory* events which usually mean that the borrower is about to default on its obligations soon.[23]

The following is a list of the events of default normally found in a loan agreement: (a) non-payment; (b) misrepresentation; (c) breach of obligations; (d) cross-default; (e) insolvency; (f) insolvency proceedings; (g) change of activity; (h) validity of agreement; (i) unlawfulness; and (j) material adverse change.[24]

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[18] Buchheit LC, How to Negotiate Eurocurrency Loan Agreements. Euromoney Publication, London (1995) p 13.

[19] For example, Clause 15 of the LMA Leverage Finance Facility Agreement.

[20] See Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 12 number 41.

[21] See Gayle C, Acquisition Finance – Syndication Best Practice, Int Comp Comm L R 13(8) (2002) pp 303–304.

[22] *Ibid*, p 305.

[23] Agarwal VK, Negotiation and Drafting Clauses in Loan Agreements: Events of Default, UNITAR, DFM Document Series, Document No 15, Geneva (March 2001).

[24] *Ibid*.

The consequences of the occurrence of an event of default are serious.[25] The occurrence of an event of default gives the lender a right to declare that: (1) the lender's obligation to pay the loan amount that remains to be paid to the borrower will cease: (2) the entire amount paid by the lender and the interest thereon and any other sum payable by the borrower becomes due and payable to the lender immediately (acceleration); (3) the borrower becomes liable for the interest for the defaulted period at the enhanced rate called default interest rate; and (4) the lender will use other remedies available to it under the contract and the applicable laws (remedies cumulative and not exclusive clause). The existence of a cross-default clause would increase the impact of an event of default even more.

Mitigation of the risk of default. The borrower (the firm) can do many things to mitigate the risk of its own default.

First, the firm should ensure that it can repay the loan capital and make interest payments when due. For example, a start-up with little income might not be able to service a loan with interest payments and repayments monthly or quarterly.

Second, the firm should generally ensure that the terms of the loan facility leave the firm enough managerial discretion to carry on its business in the normal way without the consent of lenders.

Third, the firm should ensure that the representations and warranties are qualified and diluted by suitable materiality thresholds. In addition, the firm can use disclosure against the representations and warranties (for disclosure as way to dilute contractual obligations, see Chapter 13 on due diligence). The firm should review carefully which warranties are deemed repeated after the initial drawdown and therefore may subsequently trigger an event of default.[26]

Fourth, after reaching an initial understanding about the loan facility, the firm should review the terms of its existing contracts in order to screen existing obligations that limit its rights to agree on a new loan facility and its terms. Failure to carry out an internal due diligence may, in the worst case, lead to an event that makes certain rights available to the firm's other lenders or contract parties. For example, a new loan facility can amount to a covenant default or be regarded as a material adverse change that lead to acceleration of an existing agreement.

Fifth, the firm should examine the proposed wording of the events-of-default clause very carefully. (a) The risk of default is increased where the events-of-default clause is broad. The firm should ensure that normal business activities will not trigger an event of default. (b) The risk of default is increased where the default clause is not limited to just one corporate entity and one transaction but covers many corporate entities (such as subsidiaries and affiliated companies) and many transactions (such as other loan facilities). For example, the borrower should try to avoid the inclusion of a cross-default clause (sections 4.3 and 8.3.2 and Volume II). (c) The firm can try to dilute the events of default in various ways. Preferably, the agreement should provide for grace periods varying, say, from 15 to 60 days wherever time limits are prescribed or payment obligations are involved. In

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[25] *Ibid*.

[26] See Gayle C, *op cit*, pp 303–304.

other appropriate cases test of "materiality" may be added.[27] (d) The firm should generally ensure that the events-of-default clause does not give too much discretion to the lenders.

Sixth, the firm should examine the remedies available to lenders upon the occurrence of an event of default. For example, automatic acceleration without any grace period might cause a liquidity crisis. The firm can therefore try to ensure that remedies will not be triggered automatically (grace period). The firm should understand what it means that remedies are "cumulative" and not "exclusive".[28] In addition, the firm might prefer a clause according to which the lenders' obligations will be suspended during the period that the event of default continues rather than terminated.

For example, the following clause would protect the interests of borrowers, because the obligations of the lender would be suspended rather than terminated: "If any of the following events shall have occurred and be continuing, the Bank may by notice to the Borrower suspend in whole or in part the right of the Borrower to make drawings under the loan" (NORDISKA Sec. 9.02).[29]

Also the following clause would protect the interests of borrowers, because it lays down a grace period: "If any of the following events shall occur and shall continue for the period specified below (thirty days), then at any subsequent time during the continuance thereof, the Bank, at its option, may, by notice to the Borrower and the Guarantor, declare the principal of the loan then outstanding to be due and payable immediately together with the interest and other charges thereon and upon any such declaration such principal, together with the interest and other charges thereon, shall become due and payable immediately" (Gen. Con. IBRD, Article 7).[30]

Generally, the borrower should try to reduce the risk inherent in the drafting and interpretation of the contractual framework. For example, where the contractual framework contains both a loan agreement and a security package, the borrower can require a "loan agreement override" meaning that the negotiated position evidenced by the loan agreement should prevail over any inconsistency in the security documents.[31]

Covenant risk. Loan facility contracts typically contain covenants (see Volume II) that help to monitor the borrower, require the borrower to maintain financial thresholds, and give lenders certain rights when the borrower's finances deteriorate.

Such covenants can be too restrictive if they prevent the borrower from carrying on its business in the normal way. If covenants are too restrictive, there is a high risk of covenant default triggering the lender's remedies.

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[27] Agarwal VK, Negotiation and Drafting Clauses in Loan Agreements: Events of Default, UNITAR, DFM Document Series, Document No 15, Geneva (March 2001).

[28] See, for example, DCFR III.–3:102.

[29] Agarwal VK, Negotiation and Drafting Clauses in Loan Agreements: Events of Default, UNITAR, DFM Document Series, Document No 15, Geneva (March 2001).

[30] *Ibid*.

[31] Gayle C, *op cit*, p 301.

Some firms have been able to borrow money on easy terms that give little security to lenders (so-called covenant-lite loans). The largest issuers of covenant-lite loan instruments have been private-equity firms, which were able to dictate terms to lenders before the financial crisis that began in mid-2007. The firm is obviously less likely to default on a covenant-lite loan before actual insolvency, as there are few or no covenants to break even as the firm's finances deteriorate.

The firm can mitigate risk by limiting the scope of covenants to one or just a few corporate entities. For example, it is more difficult for the firm to comply with a covenant that covers the business of all subsidiaries and affiliated companies, and easier to comply with a covenant that only applies to one corporate entity.

Generally, covenant risk tends to be higher when absolute terms are used (for example, "the firm shall not dispose of any of its assets"). Qualified terms can help to reduce the risk of default. The borrower can thus mitigate covenant risk by adding words that dilute the covenant (for example, "the borrower shall not dispose of any of its assets, where it would have a material adverse effect on the repayment capacity of the borrower").

The firm should ensure that negative pledge and pari passu clauses do not prohibit indebtedness and security interests that are created by reason of law in the ordinary course of the firm's business. For example, freight forwarders and carriers may have a statutory security interest in goods that are in their possession.[32]

Subordination. Subordination is a way to mitigate the risk of covenant default under existing contracts (for subordination, see Chapter 6; for pari passu, see Volume II). Subordination can also be used when the firm issues loan instruments that belong to different tranches.

A subordination agreement is the opposite of a negative pledge in the sense that instead of trying to obtain priority over other parties, the creditor voluntarily agrees to subordinate its right. Subordination can often help to reduce the risk of the firm breaching pari passu clauses, because the usual wording of pari passu clauses does not cover subordinated debt (for subordination, see section 6.3).

Subordination can be contractual or based on mandatory provisions of law. The mechanics of subordination can vary from contract to contract.[33] For example, a (subordinated) creditor can agree: to postpone receipt of payments until the debt payable to the senior creditor has been discharged (complete subordination);[34] to postpone its right to be paid upon the insolvency of the debtor until the senior creditors have been paid in full (usual form of contractual subordination);[35] that the creditor is entitled to payments until the occurrence of a specified event, such as an event of default under a senior finance document.[36]

For example, a company may issue A notes and B notes. If the B notes mature six months after the A notes, they will be subordinated to the A notes (as there might not be sufficient

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[32] See, for example, § 14 of the General Conditions of the Nordic Association of Freight Forwarders (NSAB).

[33] The Law Commission, Registration of Security Interests, paragraph 6.51.

[34] *Ibid*, paragraph 6.52.

[35] *Ibid*, paragraph 6.53.

[36] *Ibid*, paragraph 6.52.

funds left to repay the B notes after the repayment of the A notes). If the A notes have been issued by an operating subsidiary and the B notes by a holding company, the B notes will even be structurally subordinated (section 6.3.5) to the A notes (as the holding company relies on assets distributed by its operating subsidiary).

Credit risk transfer, assignment. The subsequent transfer of credit risk from a lender to another financial institution can influence the position of the borrower (the firm).

Credit risk transfer can have an adverse effect on the position of the borrower by causing moral hazard problems even if the lender-borrower relationship remains formally intact (for example, the relationship remains formally intact if the lender has used credit derivatives or insurance to transfer risk instead of selling the claim outright). The behaviour of the lender towards the borrower may change at least in three ways. First, the original lender may be expected to reduce its credit risk monitoring (and the lender's role as an agent of the firm, see Volume I).[37] Second, the existence of credit risk protection might influence a lender's behaviour with respect to distressed borrowers, because loss protection changes the risk/return profiles of various alternative actions (and increase counterparty commercial risk for the firm, see Volume II).[38] Third, once the lender has transferred its credit risk, it may be in the lender's interests to cause an event that prematurely triggers payment.[39]

Even the behaviour of potential future lenders may change. Some market participants may interpret the transfer of risk as a negative signal about a borrower's creditworthiness.

Furthermore, where the claim has been assigned to a third party that took the lender's place, the assignee may be less constrained in its actions towards the borrower.

For example, German banks constrained by the need to protect their brand sold their troubled mortgage loan portfolios to Lone Star, a private-equity firm based in Dallas. It soon turned out that Lone Star could liquidate the mortgages in a more ruthless way (see Volume I).[40]

Because of the potential signalling effect and/or potential moral hazard problems, some powerful corporate borrowers may: be reluctant to accept the free transferability of their loans (see section 8.3.4 and Volume II);[41] require a clause in the loan contract which prohibits the lender from purchasing protection;[42] and refuse to provide visible credit enhancements.

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[37] BIS, CGFS, Credit risk transfer, January 2003 p 21.
[38] *Ibid*, p 21.
[39] *Ibid*, p 41.
[40] See Balzli B, Pauly C, Vollstrecker aus Texas, Der Spiegel 31/2006 pp 58–60: "Die neuen Gläubiger wollen die billig erworbenen Kredite nicht verwalten, sondern möglichst schnell verwerten - ohne Rücksicht auf Verluste."
[41] BIS, CGFS, Credit risk transfer, January 2003 p 21.
[42] BIS, CGFS, Credit risk transfer, January 2003 p 41.

In the English case of *Essar Steel Ltd v The Argo Fund Ltd,*[43] expert evidence indicated that restrictions on transferability in syndicated loan agreements were not uncommon and that there were a number of reasons why potential parties to such agreements might wish some such restriction. These included: the preservation of a continuing relationship between the borrower and lenders and between the lenders themselves; minimisation of the costs of administration; and the need to retain replacement lenders likely to observe the law and regulatory guidelines.

In this case, parties to a syndicated loan agreement had used the standard 1997 Loan Market Association form. Following Essar's drawdown of the entirety of the loan, Argo, a hedge fund, acquired from members of the syndicate a substantial part of the debt at a substantial discount. Argo sought repayment in full of the debt that it had purchased. Now, Clause 27 of the LMA Agreement provided for two modes by which Syndicate members could pass their rights under the Agreement to another: one by way of assignment on notice to Essar, the other by way of transfer, which also operated to transfer obligations as well as rights, amounting to a novation. As for transfer, the interpretation clause defined a "Transferee" as: "a bank or other financial institution to which [a Syndicate member] seeks to transfer all or part of such [member's] rights and obligations hereunder in accordance with the provisions of this Agreement." The case concerned the meaning and effect of the provision restricting the syndicate members' entitlement to transfer their rights and obligations to entities that are "a bank or other financial institution". The Court of Appeal held that the provisions of the 1997 version of the LMA agreement permitted a transfer to a hedge fund.

Restructuring. It can be expensive both for lenders and the borrower (the firm) if the lenders actually use the remedies available to them upon the occurrence of an event of default. Both the firm and the lenders may therefore prefer to restructure the debt when the firm gets into trouble. Restructuring could take the form of changing the terms of the debt or converting the debt into shares (equity). Restructuring can range from voluntary restructuring based on an agreement between the parties to involuntary restructuring based on a court order.

The easiest way to restructure the debt is by changing its terms. The borrower might negotiate to change the repayment date or alternatively it might take out new borrowing on completely different terms, with the new borrowing being treated as repaying the old borrowing.

Alternatively, the lenders may agree to convert the debt into shares. The terms of the conversion will indicate whether there is a release of part of the debt in exchange for the issue of shares, and how much of the debt is treated as released. In the EU, the conversion of debt into shares will be constrained by the legal capital regime (see below) and require shareholder consent (pre-emptive rights). In addition, the conversion may be regarded as a form of issuing shares other than for a cash consideration, in which case particular requirements as to form, expert opinion, valuation, and the minimum value of the consideration would have to be complied with (see section 5.12). This is important, because the reason why debt is converted in the first place is that the firm will not be able to repay it in full. Whereas some Member States would regard the nominal value of the debt as

[43] Essar Steel Ltd v The Argo Fund Ltd [2006] EWCA Civ 241.

"cash" (England),[44] others would regard the market value of the debt as a consideration "other than cash" (Germany).[45]

The restructuring of bond issues on a contractual basis depends on the governing law and the terms of the loan. It typically requires either consensus or a majority decision.

In the German case of *Deutsche Nickel AG,* the restrictive terms of the German Bond Act of 1899 (Schuldverschreibungsgesetz, SchVG) forced the company to move to England and finish its restructuring there. As the old Act is less flexible than English law, it is in the process of being modernised.[46] The "London Approach", the INSOL principles, and debt restructurings under English law in general can better be discussed in specialist books.[47]

In many countries, restructuring can be based on insolvency laws and proceedings modelled on Chapter 11 of the US bankruptcy code. In the past, the insolvency laws of European countries were very severe. The board of a company that became unable to pay its debts often had a duty to file for insolvency within a short period of time and insolvent companies often ended up being liquidated. Many countries have introduced reforms for the purpose of rescuing firms (see Volume I).

The Regulation on insolvency proceedings has, in effect, made it easier for creditors and firms to seek insolvency in countries other than a company's official home. The Regulation applies to "collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator"[48] and therefore also to collective proceedings for the restructuring of firms.[49] The Regulation provides for the international jurisdiction of courts (or similar bodies)[50] and sets out the governing law.

The Regulation enables the main insolvency proceedings to be opened in the Member State where the debtor has the centre of his main interests and secondary proceedings to be opened in the Member State where the debtor has an establishment. However, the main rule is that the law of the Member State of the opening of the proceedings (lex concursus) determines all the effects of the insolvency

[44] Sections 589(5)(a) and 583(3) of the Companies Act 2006.

[45] Hüffer U, AktG (2002) § 27 number 25: "Die Probleme liegen nicht in der Einlagefähigkeit, sondern der Bewertung." "Werthaltig ist die Forderung nur insoweit, als die AG imstande wäre, sie ohne Kapitalerhöhung zu bezahlen …"

[46] In February 2009, a Bill for a new Bond Act was passed ("Gesetz zur Neuregelung der Rechtsverhältnisse bei Schuldverschreibungen aus Gesamtemissionen und zur verbesserten Durchsetzbarkeit von Ansprüchen von Anlegern aus Falschberatung").

[47] For the "London Approach", see Finch V, Corporate Insolvency Law. Perspectives and Principles. Cam U P, Cambridge (2002) pp 218–229. See also INSOL International, Statement of Principles for a Global Approach to Multi-Creditor Workouts.

[48] Article 1(1) of Regulation 1346/2000 (Regulation on insolvency proceedings).

[49] Article 2(a) and Annex A of Regulation 1346/2000 (Regulation on insolvency proceedings).

[50] Recital 10 of Regulation 1346/2000 (Regulation on insolvency proceedings): "Insolvency proceedings do not necessarily involve the intervention of a judicial authority; the expression 'court' in this Regulation should be given a broad meaning …"

proceedings, both procedural and substantive, on the persons and legal relations concerned (see also Volume II).

In the *Schefenacker* case, the restructuring of what was basically a German firm was moved to England. The necessary steps were as follows:[51] (1) Schefenacker AG changed its legal form, becoming a German limited partnership, Schefenacker GmbH & Co. KG (Schefenacker KG), with Schefenacker plc as a general partner. (2) The other general partner and the limited partner either withdrew from the partnership or transferred their interests in the partnership to Schenefacker plc. (3) According to German law, this resulted in (i) Schenefacker KG ceasing to exist and (ii) the assets and liabilities of Schefenacker KG being acquired by operation of law by Schefenacker plc as the remaining general partner. (4) The new English holding company for the Schefenacker group could proceed to implement a company voluntary arrangement under English law and take advantage of the flexible insolvency laws there.

Such formal restructuring proceedings would nevertheless be expensive. The parties would not have full discretion to decide on the restructuring because, depending on the governing law, core decisions in formal restructuring decisions tend to require either a court order or approval by a majority of creditors or each class of creditors. Some creditors might therefore be able to block the restructuring and cause further costs.[52]

Thin capitalisation, lack of managerial freedom, risk of recharacterisation. Depending on the law governing the company and the law governing insolvency proceedings, a loan might in rare cases be recharacterised as a functional equivalent to shareholders' capital. This risk is characteristic of mezzanine financing.

4.3 Particular Clauses in Loan Facility Agreements

Broadly speaking, a loan agreement follows the same pattern as most commercial agreements. Some clauses are nevertheless characteristic of loan agreements.[53] There is plenty of variation in the details. Different loan agreements contain different terms, because the terms of the loan must be tailored to suit the borrower, lenders, market practice and the prevailing economic circumstances.

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[51] Proposal for a Company Voluntary Arrangement for Schefenacker plc (9 March 2007), section 2.6.

[52] The walking dead, The Economist, December 2007.

[53] For the legal aspects of loan agreements, see, for example, Adams D, Corporate Finance: Banking and Capital Markets, LPC 2003/04. Jordans, Bristol (2004); Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005); Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006). For a summary of loan covenants and the terns of loan agreements, see Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) pp 103–106 containing a text from Zimmermann C, An approach to writing loan agreement covenants, J Comm Bank Lending (1975) pp 213–228.

Standardisation v discretion. Although each loan transaction has its unique features, typically they will not influence the basic structure of the agreement and the primary categories of clauses that will be included in the agreement.

The core features of the loan agreement are determined by the nature of the loan transaction itself: the lender provides credit to the borrower who promises to repay the credit with interest according to the terms and conditions established in the loan agreement. For this reason, all loan agreements tend to have the same structure and the same basic categories of clauses. They will include clauses on conditions precedent, representations and warranties, covenants, events of default, and dispute settlement, because the core elements of all loan transactions are similar and the fundamental risks associated with all loan transactions are identical.[54]

Each lender tends to develop a model loan agreement that best addresses its concerns about the risk of non-payment and establishes the most efficient procedures for executing the transaction. The lender then seeks to have each of its borrowers accept this "standard" agreement (for the benefits of standard terms, see Volume II).

There is nevertheless diversity in the way in which clauses that belong to those categories of clauses are drafted. Lenders usually agree to deviations from their own "standard" clauses if they become convinced that the deviations are necessary.[55]

Often the discretion of the parties is constrained by the market. For example, when securities are offered to the capital market, the expectations of investors can dictate the terms of those securities and – in the case of securitisation and collateralised debt obligations – the terms of underlying agreements. The number of market customs can thus be limited in order to ensure the efficient functioning of financial markets.

Structure of the loan agreement. Clauses in loan agreements can be categorised in many ways. For example, they can be categorised into the following seven types of clauses according to the interests of the parties: (1) clauses on cash flow (the amount of the loan, the repayment schedule, the interest rate, the disbursement schedule, tax issues, and the fees associated with the loan); (2) clauses on modalities (definitions, the interest period, notice requirements, and so forth); (3) clauses on the management of counterparty credit risk (the purpose of the loan, conditions precedent, representations and warranties, covenants, changed circumstances); (4) clauses on the management of counterparty commercial risk and agency (in addition to other clauses: events of default, remedies, dispute resolution); (5) clauses on the management of commercial risk (prepayment, changed circumstances) (6) information clauses (in particular: disclosure of information as a condition precedent to closing or each drawdown, information covenants, notices); and, in syndicated loans and other multi-party contracts, (7) clauses that are necessary in multi-party contracts (the role of the agent bank, sharing).

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[54] Bradlow DD, Some lessons about the negotiating dynamics in international debt transactions. In: UNITAR, Problems and Perspectives of Debt Negotiations, DFM Document Series, Document No 9, Geneva (April 2000).

[55] *Ibid*, discussing the borrower's game plan.

Common headings therefore include: (1) Financial Obligations (a. The facility or the amount of loan; b. Currency provisions; c. Rate of interest; d. Interest period and its calculation; e. Other charges; f. Pre-payment of the loan amount; g. Repayment; h. Taxes); (2) Covenants; (3) Conditions Precedent; (4) Representations and Warranties; (5) Events of Default; (6) Applicable Law; and (7) Dispute Resolution.

Loan agreements appear to be heavily biased in favour of the lenders.[56] (a) Conditions precedent signal to the lender that the loan agreement is binding and enforceable after the terms of conditions precedent have been met. (b) The purpose of representations and warranties is to ensure that the risk level is acceptable to the lender. (c) Covenants seek to mitigate the risk that the borrower becomes unwilling or unable to perform its repayment obligations. Covenants therefore impose rectrictions on the borrower's future actions and ensure that the lender obtains information on the borrower. (d) To further enhance their confidence that the borrower can be forced to repay the money, the lender will include a series of events of default provisions and remedies provisions in the loan agreement. The lender is given the right to call the loan in default and accelerate the loan repayment if certain described events occur. (Those events tend to include the following: the borrower's failure to repay any portion of the principal amount of the loan or to make interest payments or to pay any of the fees associated with the loan on the agreed date; the borrower fails to be in compliance with any of the representations or warranties; the borrower fails to act in compliance with any of the covenants; the borrower defaults on its other financial commitments; and a material adverse change in the condition of the borrower.) (e) Loan agreements will also contain provisions to deal with the consequences of a dispute arising between the lender and the borrower.[57]

Definitions. Loan agreements can be very detailed. The Anglo-American drafting technique involves the excessive use of defined terms (see Volume II). Defined terms can be understood and negotiated only with reference to the operative clauses of the agreement in which the term appears.

For example, the borrower should pay attention to the definition of indebtedness. In most loan agreements, the defined term "indebtedness" will be used in at least three contexts: the negative pledge clause, the financial covenants, and the cross-default clause. The defined term indebtedness will most probably be used in clauses that either act as a constraint on the borrower's actions or pose a threat to the borrower. Accordingly, the borrower's negotiating objective will be to limit the scope of that term. The lender, in contrast, will prefer a wide definition of indebtedness.[58]

Typical clauses. Apart from a long list of definitions, loan agreements tend to contain a long list of other detailed clauses. Typical clauses that the borrower would, in any case, need to understand include clauses on: (a) the facility and other financial obligations; (b) the purpose of the facility; (c) drawdown; broken

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[56] *Ibid*.
[57] *Ibid*.
[58] Buchheit LC, How to Negotiate Eurocurrency Loan Agreements. Euromoney Publication, London (1995) pp 21–24.

funding indemnity; (d) commitment fee; expense reimbursement; (e) increased costs; capital adequacy indemnity; tax gross-up; (f) assignment; (g) sharing; (h) pari passu; negative pledge; permissible liens; (i) material adverse change; Eurodollar disaster; illegality; (j) payment default; default interest; cross-default; (k) governing law; submission to jurisdiction; and currency indemnity.[59]

Loan facility agreement or loan agreement. There is a distinction between a loan facility clause or agreement and a loan agreement, although those two terms tend to be interchangeable.

If the agreement contains a loan facility clause, that clause outlines the type of facility the lender will provide under the agreement, as well as the amount to be made available. The term "facility" reflects the fact that the lender makes a loan available to the borrower subject to certain conditions. The borrower may not have any obligation to borrow.

Under a loan agreement, however, the borrower has agreed to borrow money, and is obliged to draw down.[60]

This distinction can therefore be legally relevant. A loan agreement and a loan facility agreement can be regarded as two separate agreements. This means that, unless the parties have agreed otherwise, default on an individual loan agreement does not necessarily amount to breach of the loan facility agreement under the legal background rules, and termination of a loan facility agreement does not mean termination of individual loan agreements.[61]

The governing law is more likely to contain specific background rules on traditional loan agreements[62] than on loan facilities.

Representations and warranties. In the context of a loan, the representations and warranties will usually cover: (a) whether the contract is binding and enforceable (the company being duly incorporated; capacity of the company to enter into the contract; power of its representatives to enter into the contract; the finance documents being legal, valid and binding; (b) the absence of other legal matters which might prevent the contract from being legal, valid and binding (compliance with all applicable laws; compliance with other contractual obligations; no litigation); (c) ownership of assets and similar representations (for example, ownership of intellectual property rights); (d) information matters (such as the correctness of accounts, no material adverse change since the date of the last accounts, accuracy of the information memorandum (if any) and other reports provided); and (e) cross-references, where the purpose of the loan facility agreement is to finance a large transaction (such as the borrower warranting that it has no reason to believe

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[59] See, for example, Agarwal VK, Best Practices in Drafting Techniques of a Loan Agreement, UNITAR Best Practices Series in External Debt Management No 3 (2002) pp 15–17.

[60] Adams D, Corporate Finance: Banking and Capital Markets. LPC 2003/04. Jordans, Bristol (2004) p 39.

[61] German law distinguishes between Krediteröffnungsvertrag (facility agreement) and Einzelkreditvertrag (individual loan agreement). See Diem A, *op cit*, § 9 numbers 9–11.

[62] For German law, see § 607 BGB (old wording) and § 488 BGB (new wording).

that the representations and warranties under an business acquisition agreement are incorrect).[63]

Financial obligations. The choice between a loan facility and a loan agreement and generally the choice of the type of the loan influence the financial obligations of the parties. Both the lender and the borrower can undertake financial obligations. However, it is normal to agree on the financial obligations of the borrower and not of those of the lender or lenders.[64]

Financial obligations belong to the borrower's core obligations. They can be discussed in two stages.

In a loan agreement, the first stage is the taking of a loan from the lender. A loan agreement normally provides the disbursement date or dates and last date for the drawdown. It is a financial obligation of the borrower to ensure that he complies with all the conditions precedent within the time prescribed in the loan agreement, if any, and draws the money before the expiry of the last date fixed for its withdrawal.

At the second stage, the borrower assumes three kinds of financial obligations. The first financial obligation is the repayment of the loan amount in accordance with the terms and conditions of the loan agreement. The second obligation is the payment of interest as and when it falls due and payable to the lender. The third obligation is the payment of other sums due to the lender under the agreement.

Whether the lender undertakes obligations that are called "financial obligations" depends on the nature of the agreement.

Where the loan agreement provides for the payment of the loan amount in lump sum or in one instalment, no financial obligation of the lender remains to be performed after the loan amount is paid by the lender to the borrower. The agreement would thus not lay down any financial obligations of the lender.

On the other hand, if the loan agreement provides for the payment of loan amount to the borrower in instalments, some obligations of the lender remain to be performed on subsequent dates. But it is presumed that a lender would be in a position to discharge its obligations under the loan agreement. Therefore, no provision is added in a loan agreement covering the situation of non payment of loan instalment by a lender.

Other financial obligations. Other financial clauses address basic questions of payment obligations such as interest, repayment and pre-payment. The legal aspects of payment obligations have already been discussed in Volume II.

Purpose clause. In order to reduce counterparty risk, the lender will want the loan agreement to state explicitly how the borrower may use the funds. In major transactions such as takeover finance or project finance, the purpose clause is very

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[63] Gayle C, Acquisition Finance – Syndication Best Practice, Int Comp Comm L R 13(8) (2002) p 303. See also Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 326–327.

[64] See Agarwal VK, Negotiation of Specific Clauses of Loan Agreements, UNITAR, DFM Document Series, Document No 10, Geneva (May 2000).

narrow.[65] In minor transactions, the purpose clause may be wide: "The facility is to be used for general corporate purposes."

Drawdown. The agreement contains a drawdown, availability or utilisation clause. The drawdown clause deals with the modalities of when and how the borrower can actually borrow money under the loan.

Before the first drawdown, the borrower must fulfil all conditions that usually belong to conditions precedent to closing.[66] A loan agreement may not necessarily contain separate conditions precedent to closing, because the borrower will not receive any funds unless payment conditions have been fulfilled.[67]

The drawdown clause contains payment conditions. The clause will essentially say that (a) the lender will pay the agreed amount of money to the borrower's account (b) at the borrower's request (notice of drawdown),[68] (c) if the borrower has satisfied the payment conditions (conditions precedent for payment), repeated the representations and warranties, and is not in default.[69]

A simple term loan might allow the funds to be drawn in one amount on a specified day. More sophisticated facilities might allow the borrower to utilise the facility in a number of tranches up to the available amount. The loan facility agreement usually provides for minimum and maximum amounts. Revolving credit facilities offer even more flexibility, allowing repeated utilisation and repayment throughout a substantial part of the term. In major transactions, the lender will usually require the borrower to give several business days' notice of utilisation.[70]

After the drawdown, the parties are bound not only by the loan *facility* agreement but also by a *loan* agreement.[71] The distinction between the loan facility agreement and the loan agreement may influence the rights and duties of the parties under the governing law.

If the lender does not make the money available to the borrower, the lender may be held to have breached the loan facility agreement. For example, German law gives the borrower a right to damages for delay[72] or non-performance.[73] The lender might mitigate this risk by inserting a clause according to which the lender has full discretion to make the money available to the borrower.

Under the terms of a loan facility agreement, the borrower may have a right but not an obligation to draw down money. According to typical contract terms, the lender is entitled to a commitment fee in this case.

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65 See, for example, Clause 3 of LMA Leveraged Finance Facility Agreement.

66 Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 11 numbers 15–19.

67 See Clause 4 of the LMA Leveraged Finance Facility Agreement.

68 For modalities of notices under German law, see § 130 BGB.

69 Adams D, Corporate Finance: Banking and Capital Markets. LPC 2003/04. Jordans, Bristol (2004) p 47.

70 *Ibid*, p 47.

71 See Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 11 number 7.

72 § 280(1) and (2) BGB in combination with § 286 BGB.

73 § 280(1) and (3) BGB, § 281 BGB. Diem A, *op cit*, § 11 number 22.

Alternatively, the borrower may have an obligation to draw down the loan amount under the terms of the loan agreement.[74] The borrower may also have a duty to reimburse the creditor for loss caused by breach of contract.[75] The borrower can mitigate this risk by inserting a clause according to which the borrower has no obligation to draw down money unless the borrower gives the lender notice of drawdown.

Broken funding indemnity clause. Eurocurrency loan agreements nevertheless tend to contain a broken funding indemnity clause. This clause means that if the borrower fails to borrow funds under the agreement after it has given the lender notice of its intention to do so, the lender will be entitled to reimbursement for any losses occasioned by the need to liquidate ot redeploy the deposits it took to fund the loan for the interest period concerned.[76]

Commitment fee, expense reimbursement clause, other fees. A bank will invariably charge a commitment fee[77] during any commitment period regardless of whether the borrower utilises the facility.[78]

Each party bears its own costs, unless the parties agree otherwise. The borrower normally reimburses for the lender's external costs (such as lawyers' fees). Typically, each party bears its own internal costs.[79]

The expense reimbursement clause may provide that the borrower reimburses the lender for the expenses incurred by the lender in negotiating and documenting the loan or any amendments to the loan agreement, as well as any expenses that the lender may subsequently incur in enforcing its rights against the borrower.[80] The borrower may mitigate risk by ensuring that the parties agree on caps and a list of costs to be paid by the borrower.

For example, the costs could include even mandatory costs[81] and the costs of capital requirements based on the Basel II Accord[82] and implementing legislation[83] (but not minimum reserve requirements as those costs cannot be allocated to any particular credit).[84] In syndicated loans and similar multibank loans, the borrower may mitigate this risk by agreeing only to pay the costs of the agent and refusing to pay the costs of other parties.[85]

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[74] See Diem A, *op cit*, § 11 numbers 24–25.

[75] § 280(1) and (2) BGB in combination with § 286 BGB; § 280(1) and (3) in combination with § 281 BGB. See Diem A, *op cit*, § 11 numbers 26–29.

[76] See Buchheit LC, How to Negotiate Eurocurrency Loan Agreements. Euromoney Publication, London (1995) p 59; Diem A, *op cit*, p 44.

[77] In German: Bereitstellungsprovision. If the parties have not agreed otherwise, § 354 HGB and § 315 BGB will apply.

[78] The principles of § 628(2) BGB apply under German law in the event of termination due to an important reason.

[79] Diem A, *op cit*, § 26 numbers 22–25.

[80] See Buchheit LC, *op cit*, pp 106–108; Diem A, *op cit*, § 12 number 20.

[81] For example, Schedule 4 of the LMA Leverage Finance Facility Agreement.

[82] Paragraph 44 of the Basel II Accord.

[83] In Germany, § 10a KWG.

[84] Diem A, *op cit*, § 12 numbers 20–23. For German law, see §§ 10, 10a and 11 KWG.

[85] See Buchheit LC, *op cit*, pp 106–108.

In a syndicated loan, the arranger of the loan is usually paid an arrangement fee if the parties sign a loan agreement. However, the arranging bank will try to ensure that it will be paid at least a break-up fee or a similar fee in the event that its work does not lead to a signed loan agreement. Agents such as facility agents, security agents or security trustees will also be paid fees (agency fee, security trustee fee).

Other standard fees include waiver fees and transfer fees.[86]

Increased costs, tax gross-up, and capital adequacy indemnity clauses. The agreement tends to contain several clauses the purpose of which is to transfer risks to the borrower.

If an unexpected cost were to arise during the terms of the loan (for example, due to a change in regulatory requirements) it could swallow up the margin which the lender is charging on the loan. The increased costs clause transfers this risk to the borrower. Typical costs covered by the clause include the taxation of payments receivable under the loan and costs caused by capital adequacy requirements.[87]

The capital adequacy indemnity clause shares the same purpose. If the costs of the lender increase during the terms of the loan because of a change in capital adequacy requirements, the lender will want the increased costs to be borne by the borrower.[88]

The purpose of the tax gross-up clause is to shift to the borrower the risk that a withholding tax might be imposed on payments due under the loan.[89]

One of the methods used by borrowers to mitigate the risk of increased costs is, in addition to a narrow drafting, to retain the right to prepay the loan in the event that the lender wants to apply an increased costs clause or a similar clause.

Pre-payment. The right of pre-payment would decrease the borrower's interest rate risk. However, pre-payment would deprive the lender of interest earnings in two ways. The borrower would no longer be liable for the interest, and the lender loses interest so long as the funds remain unutilised (the fresh utilisation of funds requires time). Therefore, some lenders do not permit pre-payment or they permit the pre-payment after levying a penalty or premium.[90]

Covenants: event risk. The lender may require covenants in order to manage event risk. In bond issuings, typical event risks include: increased risk of non-payment; a downgrade in the credit rating of the issuer; an adverse change in the market value of the bond; an unacceptable change in the issuer's business; an unacceptable change in senior management; or an unacceptable change of control.

Covenants: lender-shareholder conflict. Covenants can also be drafted to control conflicts between lenders and shareholders. There are five major sources of conflict which arise between lenders (bondholders) and shareholders:[91]

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[86] Diem A, *op cit*, § 26.

[87] See Buchheit LC, *op cit*, pp 38–39; Diem A, *op cit*, § 20.

[88] See Buchheit LC, *op cit*, p 43.

[89] See Buchheit LC, *op cit*, p 64; Diem A, *op cit*, § 19.

[90] See Agarwal VK, Negotiation of Specific Clauses of Loan Agreements, UNITAR, DFM Document Series, Document No 10, Geneva (May 2000).

[91] See Smith CW, Warner JB, On Financial Contracting. An Analysis of Bond Covenants, J Fin Econ 7 (1979) pp 117–161 at pp 118–119 (four major sources of conflict).

- Fiduciary duties, duty of loyalty, duty of care. Generally, bondholders are not owed the same kinds of fiduciary duties, duties of loyalty, or duties of care as shareholders (directly or, as residual claimants of the company, indirectly). The difference is clearer in common law jurisdictions.[92]
- Dividend payment. If the firm issues bonds and the bonds are priced assuming the firm will maintain its dividend policy, the value of the bonds is reduced by raising the dividend rate and financing the increase by reducing investment.
- Claim dilution. If the firm sells bonds, and the bonds are priced assuming that no additional debt will be issued, the value of the bondholders' claims is reduced by issuing additional debt of the same or higher priority.
- Asset substitution. If the firm sells bonds for the stated purpose of engaging in low variance projects and the bonds are valued at prices commensurate with that low risk, the value of shares rises and the value of the bondholders' claim is reduced by substituting projects which increase the firm's variance rate.
- Underinvestment. A firm with outstanding bonds can have incentives to reject projects which have a positive net present value if the benefit from accepting the project accrues to the bondholders.

Covenants: general contents. Some types of debt covenants have been included in debt contracts for hundreds of years. Debt covenants will normally cover:[93]

- delivery of financial and other information;
- restrictions on incurring financial indebtedness and entering into sale and leaseback transactions;
- restrictions on making loans and giving guarantees;
- a negative pledge restricting the creation of security;
- requirements to maintain appropriate insurance;
- restrictions on making payments to equity investors, on redemption of equity, and on issuance of new shares;
- prohibition of asset disposals;
- prohibition of mergers, acquisitions, or investments in business or shares;
- prohibition of change of control;
- restrictions on changes in business; and
- prohibitions on amendments to key documents.

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[92] For US law, see Metropolitan Life Insurance Co. v. RJR Nabisco, Inc. 716 F. Supp. 1504. For Canadian law, see Zumbansen P, Archer SB, The BCE Decision: Reflections on the Firm as a Contractual Organization (July 14, 2008). CLPE Research Paper No. 17/2008. Available at SSRN.

[93] Gayle C, Acquisition Finance – Syndication Best Practice, Int Comp Comm L R 13(8) (2002) p 304. For event risk covenants and "designated events", see Kahan M, Klausner M, Standardization and innovation in corporate contracting (or 'the economics of boilerplate'), Virg L R 83 (1997) pp 713–770 at pp 740–742. See also Smith CW, Warner JB, On Financial Contracting. An Analysis of Bond Covenants, J Fin Econ 7 (1979) pp 117–161 at pp 125–131; Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 328–329.

From the borrower's perspective, it is important to ensure that the borrower has the flexibility to run its business in accordance with its business plan without falling foul of the covenants. To avoid an unnecessary onerous administrative burden, the borrower should ensure that the information covenants in the loan documents are consistent with its company law disclosure obligations.

From the bank's perspective, too, some flexibility is important. Flexibility will help avoid a constant stream of waiver requests.[94]

The parties typically agree on the usual covenants but modify them by reasonable exceptions and materiality thresholds.

Covenants, takeover defences, refinancing. Covenants reduce managerial discretion. They can also act as takeover defences. For example, they can act as a constraint on refinancing following a leveraged buy-out (section 18.4). On the other hand, they can also as act as a constraint on the use of pre-bid refinancing as a takeover defence (section 18.2).

This can be illustrated by the Aker Kvaerner case. Aker Kvaerner, which later changed its name to Aker Solutions, is a large Norwegian company which belongs to the even larger Aker group controlled by Kjell Inge Røkke, a Norwegian tycoon. In 2002, the company had issued subordinated bonds.[95] In 2006, Røkke decided to release capital from Aker Kvaerner through the sale of the company's Pulping and Power division and the following distribution of profits form the sale as dividends to the company's shareholders. The company therefore asked the bondholders to amend the agreements to permit a restructuring of Aker Kvaerner's debt at parent company level and to lift restrictions in the dividend covenant. Holders of Aker Kvaerner's subordinated loan voted against the company's request.

Covenants: financial ratios. Financial ratios are likely to comprise, among other things, a combination of profitability to debt and/or interest and cash flow tests.

Financial ratios enable lenders to monitor the financial performance of the borrower. The ratio levels are set by reference to the projected financial performance of the borrower at the time the loans are advanced and will enable the lenders to test whether the creditworthiness of the borrower group has deteriorated from the creditworthiness projected at the time of initial advance.

Financial ratios serve lenders in many ways. First, as a failure to maintain financial ratios would give rise to an event of default, they protect lenders in the

[94] Gayle C, *op cit*, p 304: "For example, it needs to be considered whether joint ventures will be a necessary part of the business development (these are usually restricted) or whether there will be an employee share option scheme or issue of shares to incoming management (the issue of shares may not be allowed) or whether future business acquisitions are contemplated (investments will be constrained). The borrowers also need to consider its funding arrangements for overdraft facilities and payment of employee salaries as well as its general banking arrangements (for example, without an express exception, group account netting arrangements would not be permitted)."

[95] Kvaerner Subordinated Open Bond Issues 2002/2011: ISIN NO 001 012883.8 (AKVER56) – NOK. ISIN NO 001 012884.6 (AKVER56) – USD. ISIN NO 001 012885.3 (AKVER56) – EUR.

event of a downturn in financial performance. Second, they help to determine the interest rate on the loans. Third, they can also be used as part of tests which must be satisfied before distributions can be made to other investors such as shareholders or venture capital investors.[96]

Restrictive covenants: pari passu, negative pledge, and permissible liens clauses. The pari passu clause is intended to preserve the lender against the involuntary subordination of its loan. The borrower tends to ensure that the benchmark indebtedness is qualified by the word unsubordinated: "All the obligations and liabilities of the borrower hereunder rank, and will rank, either pari passu in right of payment with or senior to all other ubsubordinated indebtedness of the borrower."[97] The pari passu clause is complemented by the negative pledge clause.

For the lender, the purpose of the negative pledge clause is to ensure that a borrower's assets will remain unencumbered and available to satisfy the claims of all general unsecured creditors should the borrower get into financial difficulties in the future. From the borrower's standpoint, the most unpopular version of the clause contains an absolute prohibition of the borrower's incurrence of future secured indebtedness. The borrower's negotiating objective with this clause is to retain as much flexibility as possible in terms of future financing alternatives.[98]

The borrower will also want certain types of secured financing transactions to be expressly excluded from the reach of the negative pledge restrictions. These exceptions are sometimes referred to as permissible liens. Although the lender will not wish to give the borrower any greater latitude to create preferential security interests in favour of other creditors than is strictly necessary for the efficient conduct of the borrower's business, the lender will agree at least to the exclusion of existing liens, normal operating liens and involuntary liens.[99]

Assignment clause. Whether a loan can be sold down depends on the primary documentation between the borrower and the original lender. The principal objective of the lender in the assignment clause is liquidity. Constraints on the lender's liquidity would mean higher costs for the borrower.

Some borrowers may nevertheless limit the right of the lender to assign the loan. This is usually done by requiring the borrower's consent to assignment. It is normal to add that the consent may not unreasonably be withheld and that the consent is not necessary in the case of assignments to affiliates of the assignor.[100]

This means also that the third-party buyer of the loan has to check the primary documentation to ensure that any transfer complies with it.

The actual methods of transfer are straightforward. The legal mechanisms are novation, assignment or sub-participation.

Novation means that the new lender (A) replaces the original lender (B) as the lender to the borrower (C) in what is, in legal terms, a completely new loan. Novation therefore involves at least three parties. If the loan is a secured one, the parties

[96] Gayle C, *op cit*, p 304.
[97] See Buchheit LC, *op cit*, pp 78–79.
[98] See *ibid*, p 83.
[99] See *ibid*, pp 89–90.
[100] See *ibid*, pp 117–118.

should pay attention to what will happen to the security in the event of novation. In civil law jurisdictions, the security typically will be released unless the security is novated as well. This requires the consent of the provider of security. In common law jurisdictions, a trust construction can be used to mitigate this problem. Generally, the legal problems relating to novation reduce the tradability of the loan.

Assignment means that the new lender (A) deals directly with the original lender (B) and becomes the holder of claims under the original loan agreement.

With novation and assignment, the A thus becomes the direct lender who may sue C in the event that C does not fulfil its payment obligations. In contrast, participation means that there is no contractual relationship whatsoever between the new lender (A) and the borrower (C). A is dependent on the original lender (B) to pass on payments of capital and interest made by C. As a rule, A may not be able to sue C directly.

Events of default: general default. Events of default are primarily designed to permit the lender to accelerate outstanding debt and/or to enforce security prior to scheduled maturities. They also allow the lender to cancel commitments or suspend further drawdowns.[101]

The events of default in a loan agreement would usually cover non-payment, breach of covenant in the finance documents, misrepresentation, cross default to other financial indebtedness, invalidity of relevant documents, insolvency and/or insolvency proceedings, litigation, rescission of the finance documents, and any material adverse change. In an acquisition loan facility (see section 20.5), rescission of the acquisition agreement would also be listed as an event of default.[102]

Payment default, default interest, and cross-default clauses. The borrower should thus pay particular attention to the regulation of default. The borrower should try to qualify its obligations to reduce the risk of default. The borrower should also try to add materiality qualifications and appropriate cure periods.[103]

For example, late payment can trigger a payment default under the contract. The borrower can try to mitigate this risk by, for example, adding a grace period of several days and a minimum amount.

The purpose of the default interest clause is to provide an incentive to comply with the terms of the agreement and to compensate the lender for increased risk after default. The borrower may propose, for example, that the default interest is triggered only after the expiry of a grace period (for unreasonable clauses, see Volume II).[104]

The cross-default clause is designed to ensure that the beneficiary of the clause will have the ability to move against the borrower or its assets at the same time as any of the borrower's other lenders: the lender will be able to protect or enforce its rights against the borrower if ever another lender to the borrower under another

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[101] Gayle C, Acquisition Finance – Syndication Best Practice, Int Comp Comm L R 13(8) (2002) p 305.

[102] *Ibid*.

[103] *Ibid*.

[104] See Buchheit LC, *op cit*, p 36.

agreement becomes entitled to protect or enforce its rights against that borrower. In drafting this clause, the parties should pay attention to the definition of indebtedness (see above).[105]

Material adverse change, Eurodollar disaster, market disruption, and illegality clauses. The agreement can become less attractive for the lender for a number of reasons. Many of them have been listed in the agreement as events that trigger a default and can thus lead to acceleration. On the other hand, there are specific clauses that deal with material adverse change, illegality, and similar cases.

For the lender, the purpose of the material adverse change (MAC) clause is to function as a catch-all term. It has become an indispensable contractual tool which is used in any document evidencing the undertaking of a bank (financing offers, mandate letters, underwriting letters, loan agreements). The absence of a material adverse change will be the agreed condition of closing and a drawdown condition, and the occurrence of a material adverse change will be an agreed termination event or an event of default.

In a loan facility agreement, the MAC clause can take three principal forms: (1) one which allows the lender to determine, in a more or less subjective and discretionary way, whether a significant adverse change has occurred; (2) that of the single-shot, which is triggered at the moment of the occurrence of a significant adverse change in the financial or operating situation of the borrower; and (3) that of the dual test, which is satisfied only (a) at the point when a material adverse change occurs and (b) if that change is likely to prevent the contracting party from fulfilling its obligations.[106]

Due to the open nature of the MAC clause, the borrower will try to ensure that it is qualified and diluted. For example, the scope of the clause could be limited to the borrower's financial condition, in which case it would not cover changes in the borrower's business or industry.[107]

The Eurodollar disaster clause refers to the situation in which a lending bank cannot fund itself in the Euromarkets in the normal way. In Eurocurrency lending, a bank is presumed to fund its loan by taking short-term deposits in the interbank market that precisely match the interest periods under the loan. The Eurodollar disaster clause is a risk transfer mechanism. It is justified by arguments similar to those advanced for the capital adequacy indemnity clause, the increased costs clause, the tax gross-up and the broken funding indemnity clause (see above).[108]

The market disruption clause is a similar clause. It deals with the risk for the lender that a reference rate (EURIBOR or LIBOR) cannot be determined or that the reference rate does not cover the lender's funding costs.[109]

The market disruption clause can contain a dynamic component which facilitates negotiations between the parties; if the parties do not reach agreement within a short period of time

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[105] See *ibid*, pp 96–97.

[106] Julien F, Lamontagne-Defriez JM, Material Adverse Change and Syndicated Bank Financing: Part 1, JIBLR 19(5) (2004) p 172.

[107] See Buchheit LC, *op cit*, pp 104–105.

[108] See *ibid*, pp 54–55.

[109] Diem A, *op cit*, § 13.

(such as within 30 days after the lender's written notice to the borrower), the lender will have a right to determine the new interest rate on the basis of its increased costs.

As a result of the drying-up of the interbank credit market in 2008, many European banks could not refinance at EURIBOR. This increased their costs and made them invoke the market disruption clause. In Germany, this raised questions about the applicability of § 315 BGB.[110]

The purpose of the illegality clause is to ensure that the lender is relieved of its obligation to advance funds, if advancing the funds becomes illegal for the lender, and the borrower is obliged to repay the loan in full, if the loan becomes illegal for the lender.[111]

Remedies available to the lender. The most important remedy available to the lender in the event of default by the borrower is acceleration of the credit and termination of the agreement. The borrower will try to ensure that the agreement provides for a grace period.[112]

Governing law, submission to jurisdiction, and currency indemnity clauses. Choice of law and choice of forum both influence legal risk (see Volume II). The choice of the currency of account (Volume II) and the forum clause is often complemented by a currency indemnity clause. According to the laws of the forum, a monetary obligation might be discharged in local currency (Volume II) instead of the currency of account. Without a currency indemnity clause, the borrower might have an economic incentive to delay paying a judgment to take advantage of a depreciation in the value of the judgment currency in relation to the currency of account.[113]

4.4 Prospectus

The issuing of loan securities will sometimes require the publication of a prospectus that has been approved by the competent authority. Prospectus rules will be discussed in the context of shareholders' capital in more detail (section 5.9.3). Some general remarks can nevertheless be made.

The Prospectus Directive provides that "Member States shall not allow any offer of securities to be made to the public within their territories without prior publication of a prospectus"[114] and that "no prospectus shall be published until it has been approved by the competent authority of the home Member State".[115]

The Prospectus Directive covers certain loan instruments. In order to ensure investor protection, the Prospectus Directive applies to equity securities and non-

[110] See Nadejda Kysel, Bankenkrise trifft die Kunden, FAZ, 22 October 2008.

[111] See Buchheit LC, *op cit*, p 49. For German law, see also § 275(1) BGB (Unmöglichkeit); Diem A, *op cit*, § 16.

[112] Diem A, *op cit*, § 22 number 65.

[113] See Buchheit LC, *op cit*, p 113.

[114] Article 3(1) of Directive 2003/71/EC (Prospectus Directive).

[115] Article 13(1) of Directive 2003/71/EC (Prospectus Directive).

equity securities offered to the public or admitted to trading on a regulated market. The scope of the Prospectus Directive is thus not limited to equity securities or to securities which have been admitted to the official lists of stock exchanges.[116]

However, there are many loan instruments to which the Prospectus Directive does not apply. For example, the Directive does not apply to securities included in an offer where the total consideration of the offer is less than €2,500,000.[117]

The obligation to publish a prospectus does not apply to the following types of offer: (a) an offer of securities addressed solely to qualified[118] investors; and/or (b) an offer of securities addressed to fewer than 100 natural or legal persons per Member State, other than qualified investors; and/or (c) an offer of securities addressed to investors who acquire securities for a total consideration of at least €50,000 per investor, for each separate offer; and/or (d) an offer of securities whose denomination per unit amounts to at least €50,000; and/or (e) an offer of securities with a total consideration of less than €100,000 (calculated over a period of 12 months).[119]

Even where no prospectus is required under the Prospectus Directive, "material information provided by an issuer or an offeror and addressed to qualified investors or special categories of investors, including information disclosed in the context of meetings relating to offers of securities, shall be disclosed to all qualified investors or special categories of investors to whom the offer is exclusively addressed".[120]

4.5 Particular Remarks on Corporate Bonds

Large companies do not have to borrow from banks; they can raise long-term debt from the markets by issuing bonds. Basically, a bond is a loan in the form of a debt security. There is a borrower (issuer of bonds) and many lenders (holders of bonds). The issuer undertakes to repay the principal and interest (the coupon) at a later date (maturity). Bonds enable the issuer to finance long-term investments with external funds. Short-term debt securities like certificates of deposit (CDs) or commercial paper (CP) are considered to be money market instruments rather than bonds and will be discussed in the following section.

Particular aspects. There are particular aspects relating to bonds. First, there is a bond market. Second, there is both a primary market and a secondary market. Third, there cannot be a market without a trading infrastructure and a post-trading infrastructure. Fourth, several regulatory initiatives have been started in recent years aimed at creating a single market in financial services across the EU, and

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[116] Recital 12 of Directive 2003/71/EC (Prospectus Directive).
[117] Article 1(2)(h) of Directive 2003/71/EC (Prospectus Directive).
[118] For a definition of qualified investors, see Article 2(1)(e) of Directive 2003/71/EC (Prospectus Directive).
[119] Article 3(2) of Directive 2003/71/EC (Prospectus Directive).
[120] Article 15(5) of Directive 2003/71/EC (Prospectus Directive).

they have an impact on European bond markets. Fifth, the nature of bonds also influences covenants and other terms.

The bond market. Bonds can be denominated in any currency and issued by various kinds of entities.

The most important market for euro-denominated bonds is that for bonds issued by *public authorities*. In 1999, public authorities were behind 57% of all euro-denominated debt securities issued by euro area entities. The share of debt securities issued by public authorities was slowly decreasing between 1999 and 2006. Slightly less than half of all euro-denominated debt securities were issued by public authorities in 2006.[121] The share of *private sector* issuers has been increasing.

Although much of the money lent by banks is raised through the taking of deposits, *monetary financial institutions* (MFIs) are the second largest group of issuers of debt securities in the euro area economy, just behind the general government sector.[122] The bulk of the debt securities issued by MFIs – accounting for nearly 90% of total outstanding – are notes and bonds that have a long original maturity.[123]

Between 1999 and 2006, the fastest growing segment by far comprised debt securities issued by *non-MFI financial institutions*. Non-MFI financial institutions comprise traditional financial institutions like insurance corporations and pension funds as well as other financial institutions like investment funds, financing arms of industrial corporations, financing arms of MFIs, and SPVs set up for asset securitisation. The high growth rates for this market segment might partly reflect the strong trend towards securitisation through SPVs.[124] In 2006, debt securities issued by MFIs and by non-MFI financial institutions represented almost half of all issues.

In contrast, *non-financial corporations* still appear to be relatively inactive as issuers of debt securities. In continental Europe, there is a preference to raise funds through bank loans.[125] Debt securities issued by non-financial corporations accounted for 14.5% of all their debt in 2002 and for 15.3% in 2006. However, many non-financial corporations issue debt securities through a financial ancillary (typically a wholly-owned subsidiary) that itself is a non-MFI financial institutions. In 2006, outstanding amounts of short-term debt securities issued by non-financial corporations accounted for 17% of all debt securities issued by non-financial corporations. Short-term securities nevertheless are more important for non-financial corporations than for public sector issuers and MFIs.[126]

While the markets for euro-denominated bonds and related derivatives are mature, securitisation markets and markets for credit derivatives are young and inno-

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[121] ECB, The euro bonds and derivatives markets (June 2007) pp 10–11.
[122] *Ibid*, p 16.
[123] *Ibid*, p 16.
[124] *Ibid*, p 10.
[125] *Ibid*, pp 11–12.
[126] *Ibid*, p 27.

vative. Empirical analysis shows that the market for euro-denominated credit default swaps leads prices of underlying corporate bonds. [127]

Primary market. Primary markets can be based on various procedures. A very common procedure is the auction (for auctions, see section 10.3.2). According to the ECB, anecdotal evidence suggests that around 70% of euro area government bonds are issued through auction. Syndication is another very common issuance procedure (for syndication, see section 4.7). Typically, syndication is chosen where specific marketing is required to attract investors or for reasons of speed. Non-government debt securities, debt securities issued by governments of smaller countries, and new types of debt security have been issued through syndication.[128]

It is increasingly common for securities to be sold on primary markets in several tranches (tap sales) so that the outstanding amount of the security increases over time. Euro area government bond tap securities are typically sold via auction. However, if the initial tranche of the tap is issued through syndication, then syndication is also sometimes used to issue further tranches of the same security.[129]

Secondary market. In Europe, trade execution via the telephone or through voice brokers dominates both inter-dealer and dealer-to-customer debt securities markets for private sector securities. A broker is an intermediary between buyer and seller. Electronic trading systems are used in particular for the trading of government bonds. Government bonds are traded much more than private sector bonds.[130] Credit derivatives are relatively new products and they have been traded electronically throughout most of their history. According to the ECB, around 80% of European CDSs were traded electronically in 2007.[131] Options and futures on euro-denominated debt securities are virtually exclusively traded electronically on Eurex (all Eurex bond derivatives are options and futures on German government bonds).[132]

From a regulatory point of view, secondary securities markets can be divided into regulated and non-regulated markets. Regulated markets are markets that fulfil a set of regulatory requirements specified in the MiFID and are recognised as regulated markets by their home Member State. The list of regulated markets is published once a year in the Official Journal and includes even bond markets.[133] Most regulated markets are operated fully electronically.[134]

Post-trading infrastructures. Trading is followed by post-trading clearing and post-trading settlement. The euro area inherited the market infrastructures of its member countries. Consolidation has mainly taken place domestically, and to only

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[127] *Ibid*, pp 5 and 56–60.
[128] *Ibid*, pp 33–34.
[129] *Ibid*, p 35.
[130] See *ibid*, pp 36–37.
[131] *Ibid*, p 45.
[132] *Ibid*, p 47.
[133] Annotated presentation of regulated markets and national provisions implementing relevant requirements of ISD (Council Directive 93/22/EEC) (2008/C 57/11).
[134] See ECB, The euro bonds and derivatives markets (June 2007) p 37.

a limited extent at the EU level. The European securities post-trading infrastructures remain largely fragmented at a cross-border level.[135]

Post-trading infrastructures comprise in particular central counterparty clearing houses (CCPs) and securities settlement systems (SSSs). A securities transaction can be executed either on a regulated market or over the counter (OTC). Information on the transaction either goes directly to the SSS in which the transaction is to be settled or is first routed to a CCP and only after CCP clearing is submitted for settlement to the SSS.[136]

Table 4.1 Post-trading Infrastructures

Trading:	regulated market or OTC
Clearing:	CCP
Settlement:	SSS

CCPs offer a range of post trading services such as becoming the only counterparty and netting (see Volume II). In most jurisdictions, the legal concept that enables a CCP to become the counterparty is either novation or open offer. Novation means that the original contract between the buyer and seller is extinguished and replaced by two new contracts, one between the CCP and the buyer and the other between the CCP and the seller. In an open offer system, there should never be a contractual relationship between the buyer and seller. If all pre-agreed conditions are met, a CCP will automatically and immediately become the counterparty.

SSSs are provided by central securities depositories (CSDs) or international central securities depositories (ICSDs). Both enable securities transactions to be processed by book entry. Physical securities may be immobilised by the depository or securities may be dematerialised so that they exist only as electronic records. In addition to safekeeping, both may provide matching, clearing and settlement. CSDs were originally organised on a national basis. CSDs also perform a notary function, that is, the registration of ownership of securities on a legal record.[137]

In 2007, there were 18 CSDs and 2 ICSDs (Euroclear Bank, based in Belgium, and Clearstream Banking Luxembourg, based in Luxembourg) which provide SSSs for debt securities in the euro area.[138]

Community law. For debt instruments, important regulatory issues include: rules on financial information available to investors (information concerning the issuer and the debt instrument itself); rules relating to trading and distribution; the framework for investment in debt instruments by institutional investors; rules relating to using debt securities as collateral; and rules relating to clearing and settlement.

The most important measures of relevance for European debt markets include: the Prospectus Directive; the Transparency Directive; the MiFID; the UCITS Di-

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[135] *Ibid*, pp 5 and 39.
[136] *Ibid*, pp 38–39.
[137] *Ibid*, pp 38–39.
[138] *Ibid*, p 42.

rective; the Market Abuse Directive; the Settlement Finality Directive and the Collateral Directive; as well as the Clearing and Settlement Code of Conduct. All financial services directives provide for home Member State control.

Prospectus. The Prospectus Directive can apply to some bond offers. In addition to shares, the Prospectus Directive also applies to debt securities when they are either "offered to the public" or "admitted to trading on a regulated market situated or operating within a Member State".[139] However, the Prospectus Directive does not apply to government bonds and similar securities issued by public authorities, or to certain non-equity securities issued in a continuous or repeated manner by credit institutions.[140] Neither does it apply to money market instruments having a maturity of less than 12 months.[141]

Although the Prospectus Directive might be applicable, the obligation to publish a prospectus does not apply to certain types of offer. This enables issuers to circumvent the duty to publish a prospectus. The obligation to publish a prospectus under the Prospectus Directive does not apply to: (a) an offer of securities addressed solely to qualified investors; and/or (b) an offer of securities addressed to fewer than 100 natural or legal persons per Member State, other than qualified investors; and/or (c) an offer of securities addressed to investors who acquire securities for a total consideration of at least €50,000 per investor, for each separate offer; and/or (d) an offer of securities whose denomination per unit amounts to at least €50,000; and/or (e) an offer of securities with a total consideration of less than €100,000 (calculated over a period of 12 months).[142]

On the other hand, some information obligations will remain even when no prospectus is required provided that the transaction falls within the scope of the Directive (for example, money market instruments do not, but the offering of bonds with a longer maturity to qualified investors does). First, "material information provided by an issuer or an offeror and addressed to qualified investors or special categories of investors, including information disclosed in the context of meetings relating to offers of securities, shall be disclosed to all qualified investors or special categories of investors to whom the offer is exclusively addressed".[143] Second, the Prospectus Directive also regulates advertisements (see section 5.9.3).[144]

The European High Yield Association and the Loan Marketing Association recommend further disclosures when securities are to be listed or otherwise publicly traded. An issuer of non-investment grade debt facilities should make publicly available the key documentation for its material debt facilities and intercreditor arrangements. In addition, an offering memorandum for a new issue of non-investment grade debt securities should disclose the key terms of the issuer's other material debt facilities and other financings, including, with respect to each material facility and instrument: key payment terms; financial covenants;

[139] Article 1(1) of Directive 2003/71/EC (Prospectus Directive).
[140] Article 1(2) of Directive 2003/71/EC (Prospectus Directive).
[141] Article 2(1)(a) of Directive 2003/71/EC (Prospectus Directive).
[142] Article 3(2) of Directive 2003/71/EC (Prospectus Directive).
[143] Article 15(5) of Directive 2003/71/EC (Prospectus Directive).
[144] Article 15 of Directive 2003/71/EC (Prospectus Directive).

guarantees and security; and terms of any intercreditor arrangements that affect such debt.[145]

Reporting, equivalent treatment. The Transparency Directive also applies to bonds that have been admitted to trading on a regulated market.[146] Debt instruments that do not fall within its scope include, for example, convertible bonds (even when they are listed)[147] and money market instruments (which typically are not listed).[148]

The Transparency Directive requires issuers to provide half-yearly financial reports[149] and to ensure that all holders of securities ranking pari passu are given equal treatment and that they have all the facilities and information to exercise their rights (including voting through electronic means).

The duty to provide half-yearly financial reports does not apply to public sector issuers;[150] there is also a €50,000 threshold per unit and optional exemptions for certain privately-owned credit institutions.[151]

The European High Yield Association and the Loan Marketing Association recommend additional ongoing disclosure obligations.[152]

UCITS. The UCITS Directive can be relevant for corporate issuers and debt markets to the extent that it sets out the type of derivatives and debt instruments that investment funds can invest in, and their conditions.[153] In June 2007, UCITS assets under management amounted to €6 trillion, and UCITS represent about 75% of the EU investment fund market.[154]

Authorisation, code of conduct. The MiFID applies to investment firms and regulated markets[155] rather than issuers in general. It harmonises the conditions for initial authorisation of investment firms,[156] pre-trade disclosure requirements,[157] and core conduct rules that investment firms must comply with when providing

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[145] EHYA and LMA Recommended Market Practices, Disclosure of Issuers of Non-Investment Grade Debt Securities (16 June 2008).
[146] Article 1(1) of Directive 2004/109/EC (Transparency Directive).
[147] Article 2(1)(b) of Directive 2004/109/EC (Transparency Directive).
[148] Article 2(1)(a) of Directive 2004/109/EC (Transparency Directive).
[149] Article 5(1) of Directive 2004/109/EC (Transparency Directive).
[150] Articles 8(1)(a) and 8(3) of Directive 2004/109/EC (Transparency Directive).
[151] Article 8(2) of Directive 2004/109/EC (Transparency Directive).
[152] EHYA and LMA Recommended Market Practices, Disclosure of Issuers of Non-Investment Grade Debt Securities (16 June 2008).
[153] See Article 19 of Directive 85/611/EEC (UCITS Directive, as amended) as well as Directive 2007/16/EC. ECB, The euro bonds and derivatives markets (June 2007) p 64.
[154] Proposal for a Directive of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), Explanatory memorandum, COM(2008) 458 final, 2008/0153 (COD).
[155] Article 1(1) of Directive 2004/39/EC (MiFID).
[156] Article 5(1) of Directive 2004/39/EC (MiFID).
[157] Articles 29 and 44 of Directive 2004/39/EC (MiFID).

services to clients,[158] among other things. According to the MiFID, detailed implementing rules should differentiate the levels of protection according to the nature of the clients (retail, professional) and the nature of the service.

As the MiFID applies to investment firms and regulated markets,[159] it can generally apply to banks (which are typical investment firms)[160] and some entities that are central counterparties (provided that they have been authorised as a regulated market by their home Member State).[161] As a result, such entities must comply with a code of conduct when providing investment services to clients.[162] For example, there is a "know-your-customer" rule applicable to investment advice (see Volume I).[163]

However, the MiFID does not apply to non-financial corporations and the financing arms of industrial corporations. This is because the MiFID does not apply: to investment activities that do not belong to the regular business of the person;[164] to "persons which provide investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings";[165] and to most persons who do not provide any investment services or activities other than dealing on own account.[166]

Furthermore, it is not the purpose of the MiFID to require the application of pre-trade transparency rules to transactions carried out on an OTC basis.[167] It is worth noting that this does not exclude the application of the code of conduct when an investment firm provides investment services in the context of OTC transactions.[168]

Clearing and settlement code of conduct. Clearing and settlement go hand in hand with trading but have so far been neglected by the MiFID. The MiFID does not regulate the operations of CCPs and CSDs as such,[169] as CCPs and CSDs do not provide "investment services" under the MiFID.[170] The MiFID has left clearing and settlement systems to be regulated by the market.

There is a code of conduct based on industry self-regulation. In 2006, the three main industry associations (FESE, EACH, ECSDA) prepared a European Code of Conduct for Clearing and Settlement that was signed today by all their members. The measures detailed in the Code address three main issues: (a) transparency of prices and services; (b) access and interoperability; and (c) unbundling of services

[158] Article 19 of Directive 2004/39/EC (MiFID).
[159] Article 1(1) of Directive 2004/39/EC (MiFID).
[160] Article 4(1)(1) of Directive 2004/39/EC (MiFID).
[161] Article 36 of Directive 2004/39/EC (MiFID).
[162] Article 19 of Directive 2004/39/EC (MiFID).
[163] Article 19(4) of Directive 2004/39/EC (MiFID).
[164] Article 4(1)(1) of Directive 2004/39/EC (MiFID).
[165] Article 2(1)(b) of Directive 2004/39/EC (MiFID).
[166] Article 2(1)(d) of Directive 2004/39/EC (MiFID).
[167] Recital 53 of Directive 2004/39/EC (MiFID). For pre-trade transparency rules, see Articles 29 and 44.
[168] Article 19 of Directive 2004/39/EC (MiFID).
[169] See nevertheless Articles 34, 35 and 46 of Directive 2004/39/EC (MiFID).
[170] See Annex I, Section A of Directive 2004/39/EC (MiFID).

and accounting separation. However, the Code will initially apply exclusively to cash equities. The Commission expects the scope of the Code to be gradually extended to include other financial instruments, such as bonds and derivatives.

Netting and financial collateral. Netting is supported by the Settlement Finality Directive[171] and collateral arrangements by the Collateral Directive[172] (see Volume II).

Market abuse, stabilisation. The Directive on market abuse can apply to bonds and will therefore prohibit both insider trading and market manipulation (for market abuse, see section 5.9.7 and Chapter 19).[173] For example, stabilisation measures are required to comply with the terms of Regulation 2273/2003 implementing the Market Abuse Directive.

Covenants and other terms. The core commercial terms of corporate bonds include the nominal amount, the issue price, the maturity date, the coupon (the interest rate), and the coupon dates (the dates on which the issuer pays the coupon to the bond holders). There will also be typical covenants and other terms required by the nature of corporate bonds.

Corporate bonds are normally unsecured. However, bonds issued by an SPV in securitisation transactions are secured on the asset pool bought by the SPV (such as a loan portfolio or collateralised debt obligations). If corporate bonds are unsecured, they can also be subordinated (for mezzanine financing, see Chapter 6).

If there is a large pool of investors, bond issues tend to be light on covenants for practical reasons (for covenants, see also Volume II). However, convertible bonds will necessarily have to contain more covenants in order to protect investors.[174]

Furthermore, the issuing process and syndication will require a contractual framework (see sections 4.7 and 5.10.2).

4.6 Particular Remarks on Securities in the Money Market

The term "money market" generally refers to the wholesale market for low-risk, highly liquid, short-term debt instruments and denotes a part of the capital market that is different from the equity market and the bond market. Through the money market banks and other entities can receive large amounts of money from other banks and liquid entities. The interbank money market can dry up in extreme situations when banks are not regarded as low-risk borrowers.

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[171] See, in particular, Article 3(2) of Directive 98/26/EC (Settlement Finality Directive).
[172] Directive 2002/47/EC (Collateral Directive).
[173] For the list of financial instruments to which the Directive applices, see Article 1(3) of Directive 2003/6/EC (Directive on market abuse).
[174] See Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 517–522.

The euro area money market plays a crucial role in transmitting the monetary policy decisions of the ECB (see Volume II), and the Eurosystem's "General Documentation" framework provides information about market practices.[175]

The instruments traded on the short-term securities market include government securities (mainly treasury bills) and securities issued by private entities. Securities issued by private entities are mainly commercial paper (which are short-term securities traditionally issued by non-financial corporations) and certificates of deposit (which are short-term securities issued by banks).[176]

The growth in popularity of loan facilities, under which the borrower's payment obligations are contained in debt securities issued pursuant to the facility, has blurred the distinction between bank lending and debt securities.[177]

Commercial paper. The term commercial paper (CP) refers to short-term securities where "an unsecured promissory note [is] issued for a specified amount and maturing on a specific day. All commercial paper is negotiable, but most paper sold to investors is held by them to maturity. Commercial paper is issued not only by industrial and manufacturing firms, but [also] by finance companies. Finance companies normally sell their paper directly to investors. Industrial firms, on the other hand, typically issue their paper through dealers. Over the years, bank holding companies, municipalities and municipal authorities have joined the ranks of commercial paper issuers."[178]

The issuers of medium-term notes (MTN) are generally the same type of institutions that may issue CP. The emergence of a market for MTN had its origins in the commercial paper markets whereby MTNs were initially CP with longer maturity.[179]

Integretion among national commercial paper markets is still low and a common internal market for commercial paper does not yet exist.[180]

Euro commercial paper. The euro commercial paper (ECP) market emerged in the early 1980s and was characterised by US dollar-based uncommitted programmes with a small group of intermediaries acting as dealers for each programme. ECP did not comply with SEC exemptions in the USA and could not, therefore, be sold to US investors. Since then, the ECP market has developed into a multi-currency short-term market. It is international in terms of issuers, investors, and currencies. London-based dealers distribute ECP around the world. Most other major ECP markets are largely focused on domestic issuers and investors.[181]

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[175] Guideline of the European Central Bank of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7) (as amended); EFMLG, The Money Market: Legal Aspects of Short-term Securities, Consultation Report (2 September 2002) p 9.

[176] EFMLG, *op cit*, pp 11–12.

[177] Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006) paragraph 4.1.

[178] Stigum M, The Money Market, third edition (1990) p 48, cited in EFMLG, The Money Market: Legal Aspects of Short-term Securities, Consultation Report (2 September 2002) p 14.

[179] EFMLG, *op cit*, p 15.

[180] *Ibid*, pp 47–48.

[181] *Ibid*, p 34.

Community law. Due to the diversity of short-term securities and the classes of instruments negotiated on national money markets, the specific legal nature and the characteristics of such instruments have largely been left to be regulated by the Member States.[182]

Short-term securities nevertheless raise a number of questions of Community law. Many Community directives refer to money market instruments. Can the issuing of short-term securities therefore be regarded as the taking of deposits and governed by banking laws? Does the issuing of short-term securities require the publishing of a prospectus approved by the competent authorities? Is there a duty of disclosure under the MiFID?

Banking laws. The Capital Requirements Directives[183] prohibit "persons or undertakings that are not credit institutions from carrying on the business of taking deposits or other repayable funds from the public".[184] While the scope of "taking deposits or other repayable funds" is "as broad as possible" and covers not only deposits but may take even other forms such as the continuing issue of bonds and other comparable securities,[185] those activities are not prohibited if they are not directed to "the public". For example, certain commercial paper will not be treated as deposits under English law if they fall within the exclusions of the RA Order.[186]

Prospectus, transparency. Typically, neither the Prospectus Directive nor the Transparency Directive apply to money market instruments. The securities to which the Prospectus Directive applies do not include money market instruments having a maturity of less than 12 months. For these instruments, national legislation may be applicable.[187] The Transparency Directive only applies where securities have been admitted to trading on a regulated market,[188] and money market instruments (which typically are not listed) will not fall within its scope.[189]

MiFID. Unlike prospectus and transparency requirements, the MiFID can apply in the context of money market transactions.

The MiFID applies to investment firms and regulated markets.[190] For the purposes of the MiFID, investment firm means "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis".[191] Investment services can relate to short-term securities. For example, money market instruments are financial instruments covered by the MiFID[192]

[182] *Ibid*, p 15.
[183] Directive 2006/48/EC and Directive 2006/49/EC.
[184] Article 5 of Directive 2006/48/EC (Capital Requirements Directive).
[185] Recital 6 of Directive 2006/48/EC (Capital Requirements Directive).
[186] Article 9 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (as amended). See Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006) paragraph 10.12.
[187] Article 2(1)(a) of Directive 2003/71/EC (Prospectus Directive).
[188] Article 1(1) of Directive 2004/109/EC (Transparency Directive).
[189] Article 2(1)(a) of Directive 2004/109/EC (Transparency Directive).
[190] Article 1(1) of Directive 2004/39/EC (MiFID).
[191] Article 4(1)(1) of Directive 2004/39/EC (MiFID).
[192] Annex I, Section C(2) of Directive 2004/39/EC (MiFID).

and one of the forms of investment services covered by the MiFID is the "placing of financial instruments".[193] Money market instruments here mean "those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment".[194]

However, the MiFID does not apply to corporate issuers of money market securities. The MiFID does not apply to investment activities that do not belong to the regular business of the person.[195] Neither does the MiFID apply to "persons which provide investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings";[196] or to most persons who do not provide any investment services or activities other than dealing on own account.[197]

Regulated markets. Community law often refers to the concept of regulated markets. The Member States' domestic CP or euro CP markets typically do not qualify as regulated markets.[198]

For example, in order to be eligible as collateral for Eurosystem credit operations, marketable assets must comply with certain eligibility criteria.[199] One eligibility criterion for marketable assets is that the debt instrument must be admitted to trading on a regulated market as defined in the MiFID, or traded on certain non-regulated markets specified by the ECB.

The European Commission publishes a list of all regulated markets in the Official Journal of the European Union at least once a year, and makes the list of regulated markets available on its website.[200] The assessment of non-regulated markets is made by the Eurosystem and is based on three principles: safety, transparency, and accessibility. As a result of reduced entry barriers and specialisation in trading segments, the list of regulated markets is subject to great turnover.[201]

Market abuse. The Directive on market abuse can apply to money market instruments (for market abuse, see section 5.9.7 and Chapter 19).[202]

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[193] Annex I, Section A of Directive 2004/39/EC (MiFID).
[194] Article 4(1)(19) of Directive 2004/39/EC (MiFID).
[195] Article 4(1)(1) of Directive 2004/39/EC (MiFID).
[196] Article 2(1)(b) of Directive 2004/39/EC (MiFID).
[197] Article 2(1)(d) of Directive 2004/39/EC (MiFID).
[198] See Annotated presentation of regulated markets and national provisions implementing relevant requirements of ISD (Council Directive 93/22/EEC) (2008/C 57/11); EFMLG, The Money Market: Legal Aspects of Short-term Securities, Consultation Report (2 September 2002) pp 17 and 23.
[199] Guideline of the European Central Bank of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7) (as amended).
[200] Article 47 of Directive 2004/39/EC (MiFID).
[201] See Annotated presentation of regulated markets and national provisions implementing relevant requirements of ISD (Council Directive 93/22/EEC) (2008/C 57/11).
[202] Article 1(3) of Directive 2003/6/EC (Directive on market abuse).

Settlement finality and collateral. In money markets, participants can benefit from the Settlement Finality Directive and the Collateral Directive (see Volume II).

Some particular legal aspects of CP. From a legal perspective, the issuing of short-term debt securities is, as a rule, less complicated than the issuing of long-term bonds.

Community law does not lay down any detailed substantive rules applicable specifically to short-term securities, such as commercial paper. The absence of a specific substantive EU regulatory regime means that the matter is left to national legislators and authorities to address at a national level. There are different domestic legal regimes in the various Member States.[203]

Four main features characterise European CP markets: CP are (1) wholesale instruments (2) that are short-term, (3) lightly documented and (4) flexible. (1) CP are issued in large minimum denominations and bought only by professional investors who do not need to be protected in the same manner as retail investors. (2) Because of the short maturity of CP, investors take a short-term credit risk and most investors hold CP to maturity. (3) CP can be lightly documented and regulated because only professional investors subscribe to them and bear a short-term credit risk. The documentation contains only a minimum of disclosure and credit protection provisions. (4) Light documentation and light regulation contributes to the flexibility of CP. Flexibility helps to reduce transaction and funding costs.[204]

The content of the contractual documents governing the issue of CP is a matter between the issuer and the other parties to the agreements. The parties usually agree on a standard subset of documents. The note itself would contain traditional basic terms of payment obligations (for the basic terms, see Volume II).[205]

Some particular legal aspets of ECP. As regards ECP programmes, German issuers tend to use German law,[206] but English law governs most ECP programmes.[207]

All the provisions which may be applicable to the borrower's ECP issues are agreed in advance between the borrower and the group of financial institutions that act as "dealers". The general terms of the issues are set out in the programme documentation, with the commercial terms being agreed at the time of the relevant issue.[208]

ECP usually does not bear interest, but is instead issued at a discount to its repayment amount. Since the investors' credit risk is short-term, there is no real

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[203] EFMLG, The Money Market: Legal Aspects of Short-term Securities, Consultation Report (2 September 2002) pp 47–48.

[204] *Ibid*, 44–45.

[205] *Ibid*, pp 46–47: Currency, denomination, maturity, and respective definitions. Interest calculation, floating/fixed/index. Termination events/events of default (if any). Tax. Instructions for payment/repayment/early redemption. Form of the note/global note. Settlement, issuing and clearing procedures. Governing law, place of performance and jurisdiction.

[206] *Ibid*, p 46.

[207] *Ibid*, pp 34 and 45.

[208] Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006) paragraph 4.4.

need for special credit protection, and so ECP does not contain events of default or a negative pledge provision. It does, however, contain a tax gross-up in the normal Eurobond form.[209]

Under English law, the legal basis of ECP is physical bearer paper containing a promise to pay. By market convention, ECP takes the form of an immobilised global certificate lodged with a central securities depository such as Euroclear or Clearstream. No fully dematerialised system exists in England. The law of the location on the securities depository holding the immobilised global certificate governs the nature of the investor's rights in ECP.[210]

Some particular legal aspects of euro medium-term note programmes. The purpose of particular Euro medium-term note programmes (EMTM programmes) is to reduce documentation and other costs of each issue by standardising the terms on which the company issues securities (for standardisation, see Volume II). According to Fuller, "[t]his is done by setting out in the documents constituting the programme all the provisions which it is envisaged may be applicable to the company's issues, with the documentation for a particular issue (usually called a final terms document or a pricing supplement) needing only to set out the commercial terms (such as maturity date, interest rate, issue prices, etc) and to apply or disapply provisions of the programme documentation as appropriate. The programme can be established either with or without a trustee. Issues are made to financial institutions who have been appointed in advance as dealers under the programme. Most programmes also allow for issues to be sold by means of a syndicate of financial institutions. One important difference from a loan facility is that, whereas at least some of the banks under a loan facility are usually committed to lend, EMTM programmes are uncommitted, in that the dealers are not under any prior obligation to purchase the securities, and it is a matter for agreement between the company and a dealer at the time of each proposed issue."[211]

Some legal aspects of the US commercial paper market. The US commercial paper market is influenced by the general requirement under the Securities Act of 1933 to register securities with the Securities and Exchange Commission (SEC). USCP are securities issued to qualify for an exemption from the registration requirement.[212] Where USCP are issued under an exemption from registration in the 1933 Act, no disclosures are required. However, it is market practice to provide a simple disclosure document to potential investors. In principle, USCP could be resold under a private placement exemption in the 1933 Act. USCP dealers need not register with the SEC as broker-dealers but most CP dealers are registered because they are engaged in other activities that require registration with the SEC.[213]

The US commercial paper market also benefits from an exemption under another federal statute. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) was introduced, inter alia, to limit tax evasion by US taxpayers. One of

[209] *Ibid*, paragraph 4.3.
[210] EFMLG, *op cit*, pp 39–40.
[211] Fuller G, *op cit*, paragraph 3.13.
[212] See in particular Section 3(a)(3) of the 1933 Act.
[213] EFMLG, *op cit*, p 43.

the principal purposes of TEFRA is to discourage the issue of bearer bonds in the US and to encourage US investors to hold bonds in registered form.[214] TEFRA does not apply to: (a) registered debt securities; (b) debt securities with a maturity of one year or less (that is, commercial paper); or genuine secondary market transactions.[215]

4.7 Particular Remarks on Syndicated Loans

As described earlier in Volume II of this book, syndicated loans are an important form of multi-party contracts. All multi-party contracts raise particular legal questions on: representation; the rights and duties of the agent representing two or more parties on the same side; the rights and duties of parties on the same side; the distribution of power generally; the distribution of risk; and exit and entry.

From the perspective of the borrower, syndicated loans are special because of their very nature: there are many lenders, and there typically is a party who represents the interests of all lenders. The identity of that party can change during the course of the negotiation process and during the terms of the contract. This acts as a constraint both during the pre-signing negotiation phase (it is difficult to agree on other than the usual terms) and during the term of the syndicated loan (it is difficult to agree on amendments if they have to be agreed by all or many lenders).

Furthermore, syndicated loans are increasingly traded on secondary markets. The liquidity of syndicated loan instruments is increased if the terms of syndicated loans are standardised. In Europe, the standardisation of documentation initiated by the Loan Market Association has contributed to improved liquidity on secondary markets.

The rights and duties of banks are regulated in two main contracts: the syndicated loan agreement (the contract with the borrower); and the intercreditor agreement (the contract between lenders).

The syndicate. In a syndication procedure, a group of banks (the syndicate) intermediates between the issuer and investors. In virtually all cases in the European market, the syndicate banks also act as underwriters. Syndication on an underwritten basis means that the syndicate banks firmly buy from the issuer the issued securities and keep on their own books those securities that they cannot sell on to final investors. The placement risk is thus borne by the syndicate. Syndication where the placement risk is borne by the issuer is called "syndication on a best-efforts basis". It is very rare.[216]

For example, when German ball bearing maker Schaeffler made a hostile bid for Continental AG in 2008 (see section 19.3), the bid was backed by a large syndicated loan. The loan was fully underwritten and consisted of a term loan facility and a revolving loan facility.

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[214] Fuller G, *op cit*, paragraph 14.6.

[215] *Ibid*, paragraphs 14.6 and 14.34.

[216] ECB, The euro bonds and derivatives markets (June 2007) p 34.

When the meltdown of financial markets in 2008 made it difficult to sell debt securities to investors, the syndicate banks had to keep the loan in their own books.

Fixing of price. In the case of large government bond issues, the syndication procedure is typically very flexible and does not follow pre-defined rules. For smaller issues, in particular for corporate bonds, syndication is often organised as a fixed-price reoffering. An alternative to fixed-price reoffering is the pot deal.

The ECB describes a *fixed-price reoffering* as follows: "First, the syndicate banks collect information on potential demand from investors. The syndicate and the issuer then fix a price at which the banks buy the issue from the issuer and another, possibly slightly higher price at which the syndicate members agree to sell the securities on to investors. After a specified period of time, the syndicate dissolves and the banks are allowed to sell the remaining securities at a lower price."[217] This is how the ECB describes the *pot deal*: "In a pot deal, a range of possible issue prices are fixed and the final issue price is then set on the basis of firm investor orders collected in one common book ("pot") and negotiations between the syndicate and the issuer. In the case of pot deals, the price risk is usually borne by the issuer."[218]

Different functions of syndicate banks. As there are many lenders, there must be a division of responsibilities. As a syndicated loan is a multi-party contract, the lenders will have plenty of mutual responsibilities. A participating bank can be the lead manager, member of the management group, one of the arranging banks, the book-runner, the documentation bank, the agent, an underwriter, and/or an investor on the secondary market.

Arranger. The majority of syndications involve one bank, the "arranger" negotiating the broad terms of the loan with the borrower and organising a syndicate of banks to participate directly in the facility agreement. The facility agreement will include "syndication" clauses designed to assist the arranger in syndicating the loan.[219]

The arranger will, in practice, try to ensure that the terms and conditions of the facility agreement are what it considers to be usual, as the arranger will fear that differences from market practice may adversely affect its ability to syndicate the loan.[220]

In principle, the LMA standard loan agreement could provide a common template as a basis for negotiations.[221]

Arranging banks. There is a contract on marketing and/or underwriting between the borrower and the arrangings banks. The arranging banks will work either "on a best efforts basis" (meaning that they will try to get other banks to subscribe for the loan but do not promise to subscribe for what is left) or "on an underwritten

[217] *Ibid*, p 34.
[218] *Ibid*, p 34.
[219] Gayle C, Acquisition Finance – Syndication Best Practice, Int Comp Comm L R 13(8) (2002) p 300.
[220] *Ibid*, p 301.
[221] *Ibid*, p 305.

basis" (meaning that they agree to subscribe for the loan and will sell the loan to other investors).

Arrangers have different functions. The book-runner will coordinates marketing efforts and sell the loan. The documentation bank will coordinate documentation. The agent bank, facility agent, and paying agent will take care of the flow of information and payments. In any case, their obligations are "pure agency" obligations meaning that they do no guarantee that payments will be made by other banks.

Management group. If there is a management group, the management group negotiates with the borrower and drafts the agreement on the syndicated loan.

Lead manager. The lead manager does the same things as the management group. Typically, a bank drafts a preliminary contract document with the borrower and the term sheet. The contract document is "subject to contract" (not yet binding) and resembles a letter of intent. The term sheet contains information about the core commercial terms of the loan (the amount of the loan, the interest rate, maturity, the currency of the loan, and so forth). If the borrower is happy with the terms promised by the bank, the bank is given a mandate.

The bank will then draft loan documentation and an information memorandum as lead manager and send the information memorandum to potential participants. This will raise questions about the lead manager's liability for the contents of the information memorandum. As a rule, the lead manager owes a duty of care to potential lenders but is responsible for its work process rather than the result. In other words, it has a "duty to act with due diligence and with reasonable care". The information memorandum will contain limitations of liability to this effect.

The lead manager may in some cases promise that that the loan will be subscribed for.

Facility agent. The bank appointed as the "facility agent" for the syndicate banks will administer the loan, collect and distribute interest, collect information from the borrower, distribute information to the syndicate banks, and take instructions from the syndicate banks on certain key aspects such as whether or not, following a default, the loan should be accelerated. The arranger often is appointed as the "facility agent".[222]

Transaction costs. The arranger or lead manager will want all syndication costs to be passed onto the borrower. The borrower may seek to impose limits on costs during the negotiation stage.[223]

The syndicated loan agreement. The syndicated loan agreement resembles a bilateral loan agreement but contains additional terms which are necessary because of the existence of many lenders and, in many syndicated loans, tranching.

Duties several. According to agreed terms, the responsibilities of the banks are "several" rather than "joint". A bank will thus not be responsible for the fulfilment of another bank's duties and banks divide risk on the basis of their share of the loan.

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[222] Gayle C, *op cit*, p 300.
[223] *Ibid*, p 302.

For example, this is a typical obligations several clause: "Nature of bank's obligations. The obligations of each Bank under this Agreement are several. The failure of any Bank to carry out its obligations under this Agreement shall not relieve the Borrower of any of its obligations under this Agreement, nor shall any Bank be responsible for the obligations of any other Bank under this Agreement."

Prepayment. When tranching is used, loan documentation can require prepayment of the senior loan facility or even other loan facilites in circumstances which are likely to increase risk. The borrower should review such provisions and their cost implications in light of its plans for the future.[224]

In order to mitigate the borrower's risk exposure, the mandatory prepayment events should be subject to the usual exceptions (such as minimum amounts) and qualified by waiver periods (such as the permission of permit reinvestment in the business within specified time periods after the sale of assets).[225]

Majority/all bank consent. The borrower wants a speedy consent process when seeking necessary consent under the facility agreement. The shortest consent process would be approval by the agent. At the other extreme, the matter may require the consent of all banks or a qualified majority of banks (typically 2/3 by number and/or commitment). Majority bank approval is more likely to be agreeable to the arranger for matters which are not leverage enhancing or do not affect security or otherwise relate to enforcement.[226]

The intercreditor agreement of lenders. The intercreditor agreement of lenders regulates the mutual rights and duties of banks. Typical terms set out: the agent's duties and liability; the procedure for the lenders' decision-making; and sharing.

Agent's duties and liability. According to the terms of the intercreditor agreement, the agent will owe "fiduciary duties" or similar duties to the other banks. The term "fiduciary duties" is used in common law countries. In civil law countries, various forms of disclosure duties and duties of loyalty serve the same purpose and are functional equivalents to "fiduciary duties".

As said above, the agent will only assume liability for its work process. It will not assume any responsibility for the result of its work. The work process and the duties of the agent include, for example, a duty to: inform lenders about a breach of contract by the borrower; and organise decision-making by the lenders. The following clause from a fictive Syndicated Loan Agreement provides an example of some of the agent's core duties (a real clause would be longer and more detailed):

[224] *Ibid*, p 303.
[225] *Ibid*, p 303.
[226] *Ibid*, p 302.

Table 4.2 Agent's Duties

"The Agent, the Managers and the Banks. Each Manager and each Bank (other than the Agent) hereby irrevocably appoints the Agent to act as its agent under, and in connection with, this Agreement and irrevocably authorises the Agent to exercise such rights, powers and discretions as are specifically delegated to the Agent by the terms of this Agreement, together with all such rights, powers and discretions as are reasonably incidental thereto. The Agent has only those duties which are expressly specified in this Agreement and those duties are solely of a mechanical and administrative nature. The Borrower shall, unless it is aware or should be aware of any irregularity, be entitled to assume that the Agent represents the Banks or the Instructing Group, as the case may be, and that all the necessary permission and consents have been obtained."
"The Agent may assume that any representation made by the Borrower in connection with this Agreement is true."
"The Agent shall: promptly inform each Bank of the contents of any notice or document received by it from the Borrower under this Agreement; promptly notify each Bank of the occurrence of any Event of Default or any default by the Borrower in the due performance of, or compliance with, its obligations under this Agreement of which the Agent has actual knowledge or actual notice; and except where otherwise provided in this Agreement, act as agent under this Agreement in accordance with any instructions given to it by the Majority Banks, which instructions shall be binding on all of the Managers and the Banks."
"Notwithstanding anything to the contrary expressed or implied in this Agreement, neither the Agent nor any of the Managers shall be bound to enquire as to whether or not any representation made by the Borrower in connection with this Agreement is true."

Decision-making by the lenders. For obvious reasons, the terms that set out the procedure of decision-making by the lenders belong to the core terms of the inter-creditor agreement.

As a rule, simple things which do not affect the core commercial terms of the syndicated loan agreement can be decided on by a majority or qualified majority of capital (typically, more than 50%, 66%, or two-thirds of the capital). These matters may include: the use of remedies in the event of breach of contract; waivers of breaches of covenant; relaxation of covenants (for example negative pledge); and whether an event is "material" or not. As said above, many events such as incorrect representations or misstatements or adverse changes must be "material" before they trigger something, and the agent typically prefers to mitigate its own risk by not undertaking to interpret "materality".

Important questions typically require consensus. For example, they might include: waiver of conditions precedent; extension of maturities; reduction of the amount of payments; reduction of the interest rate; and change of currency.

Sharing. "Sharing" or "pro rata sharing" clauses are characteristic of syndicated loans. Sharing protects both the participating banks and the borrower.

The conditions several clause and the pro rata sharing clause complement each other. A bank is not responsible for the fulfilment of other banks' duties, and a bank may have a right to collect its claims for its own benefit. However, this prin-

ciple is complemented by “sharing”. Funds repaid by the borrower to a bank in excess of that bank’s share of the loan may have to be “shared” by all banks. Sharing is typically applied to all forms of repayment like “direct payment by the borrower”, “set-off”, and “proceeds of litigation”.

For the borrower, one of the purposes of the sharing clause is to protect the borrower against rogue members of the syndicate.[227]

A sharing clause might begin like this: “Redistribution of payments. If, at any time, the proportion which any Bank (a ‘Recovering Bank’) has received or recovered (whether by payment, the exercise of a right of set-off or combination of accounts or otherwise) in respect of its portion of any payment (a ‘relevant payment’) to be made under this Agreement by the Borrower for account of that Recovering Bank and one or more other Banks is greater (the amount of that excess being called in this Clause an ‘excess amount’) than the proportion thereof received or recovered by the Bank or Banks receiving or recovering the smallest proportion thereof, then: that Recovering Bank shall pay to the Agent an amount equal to that excess amount …”

[227] See Buchheit LC, How to Negotiate Eurocurrency Loan Agreements. Euromoney Publication, London (1995) p 74.

5 Equity and Shareholders' Capital

5.1 The Equity Technique, Different Perspectives

An entity's "equity" is usually defined as a residual claim to its net assets. It ranks after liabilities as a claim to the entity's assets. "Equity" is contrasted with liabilities. Liabilities are claims that must be met before a distribution can be made to equity holders in the event of an entity being wound up.

However, "equity" must surely mean more than just a residual claim in the event that an entity is wound up. An entity will be wound up only once, that is, at the end of its corporate life. During its corporate life, an entity raises funds from a wide range of investors and makes many kinds of payments to them.

Equity as a technique, equity mix. In this book, "equity" is defined as a *technique* rather than a category of financing. The equity technique consists of three fundamental elements.

First, it means using *waterfall structures* to create a ranking of claims and claims with different risk profiles. The waterfall structures influence the valuation of claims and the firm's funding costs. A lower risk means a higher valuation and lower funding costs. A higher risk means a lower valuation and higher funding costs. The equity technique enables the firm to choose an equity and debt mix and to reduce its total funding costs through price segmentation (price differentiation).

Second, such waterfall structures are based on *legal constraints* on the distribution of particular assets to investors.

Third, where the distribution of different asset classes to investors or distributions made to different investor classes are subject to different legal constraints, the firm can use the legal framework for its own benefit and choose en *equity mix* according to its needs. For example, some categories of equity assets are necessary for accounting reasons (equity on balance sheet), the issuing of some equity instruments (shares) will influence the internal decision-making of the firm, and the use of some equity instruments (shares, subordinated debt, debt instruments belonging to a junior tranche) can be necessary if the firm wants to increase the marketability of senior debt securities to be issued by the firm.

Equity technique from the perspective of the firm. From a functional perspective, equity capital means more than shareholders' capital. There are six main reasons to use the equity technique and to create equity capital. To sum up, the firm needs equity capital: to increase its survival chances and to manage its own risk level; to manage investors' perceived risk; to reduce the overall cost of funding; and for other reasons.

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First, the firm wants to ensure that it has assets that will not have to be repaid to investors when the company needs them the most. Management of equity capital is a form of corporate risk management (see Volume I).

Second, the firm wants to influence the price of debt funding in general. The firm needs to signal to debt investors that it has a sufficient amount of assets that will not easily be repaid to anyone else. The debt-to-equity ratio of the firm is a way to manage the firm's credit rating and debt investors' perceived risk (for ratings, see Volume I). The firm cannot signal that it has a favourable debt-to-equity ratio unless it ensures that it has assets that are recognised as equity on the balance sheet according to the applicable accounting rules (for IFRS, see below).

Third, the firm may want to influence the price of certain debts. This can be achieved by issuing different classes of debt instruments each with different rights to payment and different rights to collateral (for example, secured debts, unsecured debts, subordination, or tranching).

Fourth, the firm may want to manage the valuation of its shares. The existence of different classes of shares enables the firm to manage the overall cost of share-based funding (for the management of share price, see Volume I).

Fifth, as shares are equity instruments which can confer voting rights, one of the aspects of the management of equity is the management of the firm's share ownership and control structure. The share ownership and control structure can be influenced by equity instruments directly (by issuing shares or shares with different voting rights) and indirectly (by managing the risk of the firm being taken over).

The voting rights attaching to shares mean that whoever owns enough shares will control the firm and the use of its assets. If the firm is so lean that it neither has assets that can be distributed to a controlling shareholder nor can raise such funds, the firm will be less attractive as a takeover target, because buyers would not be able to refinance the takeover by using the target's assets.

Sixth, the amount of equity can signal the quality of the firm to other stakeholders. Sometimes the amount of equity is important for reasons of compliance. The firm may have to comply with statutory minimum requirements on the amount of equity (minimum capital under the Second Company Law Directive, Basel II, the minimum capital of financial institutions, and so forth).

Equity technique from the perspective of the investor. From the subjective perspective of the investor, equity can mean various things. Let us assume that the investor only focuses on the ranking of claims. Even in this case, the investor can choose between two perspectives.

First, the investor may focus on whether other investors' investments are equity investments. In this case, equity can mean: (a) a claim that cannot be paid before the investor's own claims are paid (for example, an "equity" tranche when pooled assets are securitised); (b) a claim that cannot be paid unless the company will remain able to pay the investor's own claims (for example, prohibited distributions to shareholders when applying the US type equity-insolvency test); or (c) a claim

that has a lower ranking in the insolvency of the company (subordinated claims, the residual claims of shareholders).

Second, the investor may regard his own investment as an equity investment compared with other investors' investments. In this case, equity can mean: (a) a claim that cannot be paid before other investors' claims are paid; (b) a claim that cannot be paid unless the company will remain able to pay other investors' claims; or (c) a claim that has a lower ranking than other investors' claims in the insolvency of the company.

Perspective in general. Equity can thus mean different things depending on the *perspective*.

Let us assume that an investor buys shares from an existing shareholder. In Europe, the investor knows that the distribution of funds to shareholders is constrained by mandatory provisions of company law and that shares are equity instruments. From the subjective perspective of that *share investor*, the purchase of those instruments is an equity investment and the investor expects to be remunerated accordingly. However, the balance sheet of the company will not be affected. The company is paid nothing.

Alternatively, an investor can subscribe for new shares issued by the company against a payment in cash. Even in this case, the share investor will regard the shares as equity instruments and his investment as an equity investment. The balance sheet will be affected. How exactly the balance sheet will be affected depends on the applicable accounting and company law rules.

From the perspective of the *company*, the latter is a funding transaction which increases the company's equity capital in the functional sense (capital whose distribution to investors is to a large extent in the discretion of the company) and even in the accounting sense (capital which is recognised as equity according to IFRS and national accounting rules), whereas the former is not. In both cases, the instruments held by the investors could be described as equity instruments from the company's perspective.

From the perspective of a *debt investor*, equity capital can mean funds (1) which are in the possession of the company and (2) which either cannot be distributed to shareholders or other creditors, or can be distributed to them only on certain conditions protecting the debt investor. From the perspective of the debt investor, equity capital can consist of remuneration paid to the company for share instruments or debt instruments. However, a debt investor would not regard the price that other investors have paid for their claims as equity for the debt investor's own purposes.

Depending on the perspective, equity can thus mean: (a) an *instrument* which entitles its holder to payments which are either at the discretion of the company or effectively constrained by provisions of law or contract that protect competing investors (equity instrument), the *price paid* by the investor for such equity instruments, or the *value* of such instruments; (b) *money raised* by the company by issuing equity instruments, or *assets* which are in the possession of the company and whose distribution to investors is subject to constraints protecting the firm; (c) a certain *category of assets* in the company's balance sheet; (d) or other things depending on the *area of law* (company law, tax, accounting).

Equity from a legal perspective. This raises the question what "equity" means from a legal perspective.

There cannot be any general legal definition of "equity". Different laws with different objectives contain different definitions of equity-type capital. The categories into which capital and capital instruments are divided depend on the area of law, and the distinction made between those categories depends on the applicable regulatory objectives. Furthermore, those categories and the characteristics of capital or capital instruments that fall within each category depend on the governing law.

However, laws can have identifiable objectives in this context, and "equity" is typically governed by provisions belonging to various areas of law. As such rules do not have to share the same objectives, they do not have to define "equity" in the same way. This can be illustrated by IFRS, regulatory capital under Basel II, and company laws.

Equity according to IFRS. Although equity can mean various things, the recognition of assets as equity under the applicable accounting rules is important to all parties. There can be fundamental differences between different accounting rules in this respect. Whereas IFRS defines equity as assets that appear on a company's balance sheet after deducting all its liabilities, equity can be determined in other ways under national accounting rules (for the existence of multiple accounting regimes, see Volume I).[1]

According to IFRS, equity is one of the five elements of financial statements. The elements directly related to financial position (balance sheet) are assets, liabilities, and equity. The elements directly related to performance (income statement) are income and expenses.

The IFRS Framework defines equity as the residual interest in the entity's assets after deducting its liabilities.[2] An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.[3] A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.[4]

Depending on the governing law, equity is given various descriptions in financial statements. Corporate entities may refer to it as owners' equity, shareholders' equity, capital, shareholders' funds, or proprietorship, among other things. Equity includes various classes such as share capital, own equity instruments, and reserves.

The definition of equity according to the IFRS Framework is complemented by rules on the characterisation of financial instruments. IAS 32 lays down the distinction between equity and liabilities in the context of financial instruments.

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1 For accounting rules based on the HGB and the German Accounting Law Modernisation Act (BilMoG), see Hommelhoff P, Modernisiertes HGB-Bilanzrecht im Wettbewerb der Regelungssysteme. Konzeptionelle Bemerkungen aus Anlass des RefE BilMoG, ZGR 2008 pp 250–274.

2 Framework F.49(c).

3 Framework F.49(a).

4 Framework F.49(b).

The fundamental principle of IAS 32 is that a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form.[5] A financial instrument is an equity instrument only if: (a) the instrument includes no contractual obligation to deliver cash or another financial asset to another entity; and, (b) if the instrument will or may be settled in the issuer's own equity instruments, it is either: (1) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or (2) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.[6]

According to IFRS, increases in equity result from: (a) the issue of equity instruments; (b) contributions from owners; (c) net profits; and (d) fair value adjustments that have a positive impact on equity. Decreases in equity result from: (a) distributions to owners; (b) the repurchase of an entity's shares; (c) net losses; and (d) fair value adjustments that have a negative impact on equity.

Equity instruments include an entity's issued shares, and options and warrants held by external parties to purchase those shares.[7] Classification of financial instruments as financial liabilities or equity instruments is complex, and certain instruments may have the characteristics of both.[8] IFRS specifically define equity instruments as any contract that evidences a residual interest in an entity's assets after deducting its liabilities.[9] An equity instrument, in contrast with a financial liability, does not give rise to a contractual obligation on the issuer's part to deliver cash or another financial asset or to exchange another financial instrument under conditions that are potentially unfavourable.[10]

For example, where assets may never be distributed to shareholders or may be distributed to shareholders only with the consent of the shareholders' meeting, those assets can be regarded as equity capital, because there is no contractual obligation to make distributions. Assets mentioned in § 57(1) AktG are therefore regarded as equity for the purposes of IFRS.[11]

The application of those principles can further be illustrated by preference shares and shares in co-operatives. (1) Depending on the circumstances, preference shares can be regarded either as financial liabilities or as equity instruments. If an enterprise issues preference shares that pay a fixed rate of dividend and that have a mandatory redemption feature at a future date, the substance is that they are a contractual obligation to deliver cash and, therefore, should be recognised as a liability. In contrast, normal preference shares do not have a fixed maturity, and the issuer does not have a contractual obligation to make any payment. Therefore, they are equity.[12] (2) Members' shares in co-operative entities have

[5] IAS 32.15.
[6] IAS 32.16.
[7] IAS 39R.2(e).
[8] For compound instruments, see IAS 32R.28–32.
[9] IAS 32R.11.
[10] IAS 32R.15–18.
[11] See Kraft ET, Die Abgrenzung von Eigen- und Fremdkapital nach IFRS, ZGR 2–3/2008 pp 331–332.
[12] IAS 32.18.

some characteristics of equity. They also give the holder the right to request redemption for cash, although that right may be subject to certain limitations. The rights to request redemption causes a problem. IAS 32 provides that a financial instrument cannot be regarded as an equity instrument, where the instrument includes a contractual obligation to deliver cash to its holder. This is a serious issue for co-operatives as it has fundamentally challenged the whole basis of ownership in a co-operative enterprise. In the worst case, co-operative shares previously regarded as equity could be regarded as debt, which would have a negative impact on co-operative balance sheets and make it more difficult and expensive for co-operative enterprises to raise funding. (3) For this reason, IFRIC 2[13] gives guidance on how those redemption terms should be evaluated in determining whether the shares should be classified as financial liabilities or as equity. Under IFRIC 2, shares for which the member has the right to request redemption are normally liabilities. However, they are equity if: (a) the entity has an unconditional right to refuse redemption; or (b) local law, regulation, or the entity's governing charter imposes prohibitions on redemption (but the mere existence of law, regulation, or charter provisions that would prohibit redemption only if conditions such as liquidity constraints are met, or are not met, does not result in members' shares being equity). (4) For example, IFRS forced Metsäliitto, a Finnish forestry co-operative, to change its rules. According to the new rules, no more than one-third of the distributable surplus can be used to redeem owners' shares. Two-thirds of the distributable surplus can thus be regarded as equity.

Contributions from owners are typically economic benefits that are non-reciprocal in nature. Contributions from owners are normally made in the form of cash, in consideration for shares issued by the entity. Contributions by a parent to a subsidiary may, however, take other forms, such as the contribution of non-monetary assets, for example, property, plant and equipment or another entity, or the provision of services or interest-free loans.

Distributions by an entity to its owners are normally made in the form of dividends or a return of capital, for example a share buyback. Like contributions, distributions by a subsidiary to its parent may take other forms.

The creation and use of reserves is often influenced by legal as well as accounting requirements. Legal requirements may restrict an entity's ability to make distributions from specific reserves to its owners. Reserves will typically include: retained earnings; asset revaluation reserve; fair value reserve arising from the effect of adopting new IFRS and the subsequent remeasurement of certain financial instruments, and a foreign currency translation reserve.

Equity according to Basel II. A financial institution must have regulatory capital under the Basel II framework. The Basel II Accord contains its own definition of "equity".

For supervisory purposes, capital is defined in two tiers. Core capital (Tier 1) is complemented by supplementary capital (Tier 2). At least 50% of a bank's capital

[13] IFRIC 2 Members' Shares in Cooperative Entities and Similar Instruments. IFRIC means the International Financial Reporting Interpretation Committee of the IASB. See Regulation 1073/2005 amending Regulation 1725/2003 adopting certain international accounting standards in accordance with Regulation 1606/2002, as regards IFRIC 2.

base must consist of Tier 1 capital as defined in the Basel II Accord. Elements of supplementary capital will be admitted into Tier 2 limited to 100% of Tier 1.[14]

Tier 1 capital means equity capital and disclosed reserves. Equity capital means "issued and fully paid ordinary shares/common stock and non-cumulative perpetual preferred stock (but excluding cumulative preferred stock)".[15]

Tier 2 capital or supplementary consists of undisclosed reserves,[16] revaluation reserves,[17] general provisions/general loan-loss reserves,[18] hybrid debt capital instruments,[19] and certain subordinated term debt.[20]

The many aspects of "equity" can be illustrated by the effect of the financial crisis on the minimum capital requirements of banks. In principle, one could use three balance-sheet related ways to rescue banks after the collapse of the market valuation of their assets. Banks could be permitted to use other than market values for accounting purposes (IFRS). Alternatively, the minimum capital requirements (Basel II and the Capital Requirements Directive) could be separated from the balance sheet (IFRS), and banks could be permitted to use other than market values for regulatory purposes. The third way would be to lower the minimum capital requirements or make them more flexible (Basel II and the Capital Requirements Directive). During the financial crisis, regulators used the first alternative.

Equity in company law. In company law, the terminology varies depending on the governing law and may depend on the context.[21] In any case, the characterisation of capital as equity or debt and capital instruments as equity or debt instruments can depend on many overlapping regulatory objectives. Depending on the governing law, the main objectives can include: the alignment of accounting, tax and company law requirements; the protection of other investors; and the protection of shareholders in general and non-controlling shareholders in particular. In the EU, the company law aspects of equity are heavily influenced by the European legal capital regime. These questions will be discussed in the following sections.

[14] Paragraph 49(iii) of the Basel II Accord.
[15] Paragraph 49(i) and footnote 13 of the Basel II Accord.
[16] Paragraph 49(iv) of the Basel II Accord.
[17] Paragraph 49(v) of the Basel II Accord.
[18] Paragraph 49(vii) of the Basel II Accord.
[19] Paragraph 49(xi) of the Basel II Accord.
[20] Paragraph 49(xii) of the Basel II Accord.
[21] For English law, see, for example, Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) p 50: "[The term equity share capital] carries a precise meaning in particular contexts (such as that of the Companies Act 2006) but it is often used in a looser sense to mean the same as share capital or, in the shortened form of equity, to mean share capital, other undistributable reserves and retained earnings."

5.2 Share-based Equity and Equity That Is Not Share-based

As explained above, equity can mean many things. There are various kinds of equity instruments and therefore also various kinds of holders of equity instruments. Shareholders of a limited-liability company are holders of one particular class of equity instruments, i.e. shares issued by the company.

Equity that is not share-based. Depending on the perspective, there can also be many examples of equity capital that is not share-based. (a) The firm can reduce the debt-to-equity ratio on its balance sheet without issuing new shares. The firm can achieve this by opting not to distribute profits or by adjusting the fair value of its assets. (b) The firm can ensure that it has contract-based funding that will not have to be repaid in rough times. The most extreme case of such contracts is a perpetuity.[22] A more common method would be to ask long-term stakeholders to grant long-term loans. (c) The firm can achieve price segmentation of securities in many ways. The firm can issue subordinated debt instruments which are perceived as equity by holders of other debt instruments. Holders of adequately secured debt instruments may regard unsecured debt instruments as equity for their own purposes. Tranching enables the firm to create waterfall structures within one security issue. (d) In mezzanine finance, debt mezzanine instruments are often used as a functional equivalent to shareholders' capital (section 6.3).

Debt instruments v shares. Although the equity technique enables the firm to achieve many of the objectives of equity without turning to shareholders, there are fundamental differences between share-based equity capital and equity capital that is not share-based. The differences relate to corporate governance, the role of mandatory constraints on distributions, and other matters (such as accounting and tax).

Shareholders are an integral part of the governance of the company. Shareholders participate in the company's internal decision-making. Their rights and obligations have mainly been regulated in company law, securities markets law, and the articles of association of the company. As a rule, the corporate bodies of the company must comply with the provisions of law that lay down shareholders' rights and obligations. The holder of a very large block of shares will always be able to control the company and decide on the use of its assets.

In contrast, holders of debt instruments are not an integral part of the internal decision-making of the company. The rights and obligations of holders of debt instruments have mainly been laid down in contracts and provisions of contract law that complement contracts. Although holders of debt instruments might have a legal or de facto right to influence the management of the company by virtue of contracts and covenants, they remain outsiders. The corporate bodies of the company

[22] A perpetuity is an annuity that has no definite end, or a stream of cash payments that continues forever. For example, a perpetuity issued by the Lekdijk Bovendams water board in 1648 still continues to pay interest. Goetzmann WN, Rouwenhorst KG (eds), The Origins of Value. The Financial Innovations that Created Modern Capital Markets. OUP, Oxford (2005).

may validly choose not to comply with the company's contractual obligations; if the company fails to comply with its contractual obligations, the company might be sued, but the internal decisions taken by the company's corporate bodies would remain valid. As legal outsiders, debtors would only in extreme cases (such as insolvency or near-insolvency) be able to control the company. One could say that holders of debt instruments do not participate in the governance of a company; rather they act as a constraint on governance.[23]

The obvious difference between shareholders and debtors is that while distributions to shareholders are constrained by mandatory provisions of company law, the company has a contractual duty to repay its debts.

Why turn to shareholders? A limited-liability company can turn to shareholders as providers of share-based equity instead of other investors for many legal reasons.

First, shareholders have a number of important functions. Issuing shares not only enables the company to raise funding but also makes it possible to manage the pool of shareholders and increase its quality as the firm's agents (for shareholders as agents, see Volume I).

Second, a shareholder will usually be entitled to funds that the company distributes to shareholders at some point, and the value of shares will change over time. If investors believe that funds will be distributed to shareholders and that there will be an increase in share price, the company may be able to raise funding at lower cost.

Third, shareholders' capital increases managerial freedom. Shareholders do not have an automatic right to repayment of their capital. Company laws usually make it difficult for minority shareholders to cause the company to distribute funds to shareholders.

Fourth, constraints on the distribution of assets to shareholders can make shareholders a suitable source of equity capital where the company seeks to match a long-term investment with long-term funding.

Fifth, the issuing of shares is an established way to increase equity according to IFRS and other accounting rules, and other ways to increase equity might not be available (see "Equity according to IFRS" above).

Sixth, some existing or new shareholders may be a suitable last resort of funding because of the private benefits that they enjoy. For example, a lender might be prepared to convert a loan into new shares in a near-insolvent company if this is the only way to prevent a credit loss from occurring, and a parent company would usually keep a subsidiary alive because of the adverse consequences of failure to do so.

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[23] For the distinction between governance and constraints on governance, see Chapter 2 of Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005).

5.3 The Legal Capital Regime

There is a connection between the concepts of "equity", shares and "legal capital". The adoption of a legal capital regime in the EU for public limited-liability companies is an important way to create equity capital for those companies and to protect it.

What does a legal capital regime mean? A legal capital regime can serve many purposes and mean many things. Traditionally, the amount of capital that must be contributed to and maintained by a company is called the legal capital of the company.[24] Generally, a legal capital regime consists of staggered constraints on the distribution or use of certain asset classes in the balance sheet.

First, a legal capital regime requires the existence of *legal capital*. A legal capital regime means that certain asset classes (that is, the legal capital) in the balance sheet are subject to particular company law rules which make it more difficult to use those assets or distribute them to holders of certain instruments (such as shareholders). The constraints can be more staggered if the legal capital regime contains many asset classes. The assets covered by the legal capital regime typically include the book value of certain equity investments in the company (such as share capital and funds paid to the company for other equity instruments than shares) and even other assets (such as cumulated profits, reserves, or increase in the book value of the firm's assets).

For example, German company law prohibits the repayment of share capital.[25] This prohibition is interpreted broadly. It applies not only to payments but to all kinds of benefits with a financial or commercial value. The test is based on the balance sheet. In a GmbH, any payment or other financial advantage to shareholders is regarded as a breach of § 30(1) GmbHG where the equity as recorded in the balance sheet of the company falls short of the amount of the stated share capital (and the GmbH is in the status of an underbalance, "Unterbilanz").

Second, there are *restrictions* on the distribution or use of such asset classes. A legal capital regime typically contains company law rules that allocate power in the company, and the constraints on the use or distribution of legal capital include particular rules on *decision-making*. Typically, there will be increased separation of monitoring and management meaning that the general meeting, the court, or a creditors' body will have veto rights. There is thus a connection between a legal capital regime and *corporate governance*. In addition, the restrictions are typically *staggered*.

For example, Finnish company law provides that "own capital"[26] consists of "free own capital"[27] and "bound own capital".[28] The general meeting of shareholders has a veto right

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[24] Booth RA, Capital Requirements in United States Corporation Law. In: Lutter M (ed), Das Kapital der Aktiengesellschaft in Europa, ZGR, Sonderheft 17. De Gruyter Recht, Berlin (2006) p 717, citing Manning B, Hanks, JJ Jr, Legal Capital (1990).

[25] § 30(1) GmbHG and § 57(1) AktG.

[26] In Finnish: oma pääoma. In Swedish: eget capital.

when the board submits a proposal to reduce "own capital" by distributing it to shareholders. But while rules on the distribution of "free own capital" are flexible and shareholders can relatively freely decide how those funds will be distributed, it is difficult to distribute "bound own capital" without the consent of the court or creditors.

Third, there can be *fixed minimum capital* requirements. Fixed minimum capital requirements can be used to make the constraints more staggered and increase those constraints for some asset classes. However, fixed minimum capital requirements are not a necessary ingredient of a legal capital regime.[29] They can be used to mitigate the risk caused by the nature of the balance sheet. The balance sheet reflects past business and does not take into account the future ability of the company to make distributions; fixed minimum capital requirements can create a buffer.[30] The fixed minimum capital requirements can be absolute or relative. An absolute requirement means that the amount of an asset class in the balance sheet may not fall below a certain threshold. There can also be relative fixed minimum capital requirements. Such a requirement could typically mean that a decision that would cause the amount of an asset class in the balance sheet to fall below a certain threshold would be subject to particular constraints.

Fourth, a legal capital regime typically contains company law rules designed to prevent *circumvention*. Usual examples of such company law rules include rules that ensure that the company actually receives assets, as well as rules on share buybacks and redemptions, financial assistance, other functional equivalents to distributions (such as related party transactions or "verdeckte Gewinnausschüttung"),[31] and the recharacterisation of loans as equity because of insolvency, control, or otherwise.

For example, the MoMiG introduced the concept of shareholder loans in Germany.[32] The new concept replaced the older rules on equity-replacing loans (kapitalersetzende Darlehen). The concept of equity-replacing loans could, in rare cases, be applied even to long-term loans extended by a bank that de facto controls the company (faktische Geschäftsführung). They could be applied both to GmbHs[33] and AGs.[34] – The concept of equity-replacing loans is still applied in Switzerland.[35]

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[27] In Finnish: vapaa oma pääoma. In Swedish: fritt eget capital.

[28] In Finnish: sidottu oma pääoma. In Swedish: bundet eget capital.

[29] See, for example, Lutter M, Das (feste Grund-)Kapital der Aktiengesellschaft in Europa, Zusammenfassung der Überlegungen des Arbeitskreises „Kapital in Europa". In: Lutter M (ed), Das Kapital der Aktiengesellschaft in Europa, ZGR, Sonderheft 17. De Gruyter Recht, Berlin (2006) p 7.

[30] See Veil R, Kapitalerhaltung. Das System der Kapitalrichtlinie versus situative Ausschüttungssperren. In: Lutter M (ed), Das Kapital der Aktiengesellschaft in Europa, ZGR, Sonderheft 17. De Gruyter Recht, Berlin (2006) pp 104–105.

[31] See Fleischer H, Verdeckte Gewinnausschüttung und Kapitalschutz im Europäischen Gesellschaftsrecht. In: Lutter M (ed), Das Kapital der Aktiengesellschaft in Europa, ZGR, Sonderheft 17. De Gruyter Recht, Berlin (2006) pp 114–133.

[32] § 39(1) number 5 and § 135 InsO.

[33] §§ 30, 31, 32a, 32b GmbHG and § 135 InsO. BGHZ 31, 258; BGHZ 76, 326.

For all such reasons, the legal capital regime protects the *firm* by creating equity capital through those staggered constraints (see below). The legal capital regime is designed to protect *minority shareholders*. Indirectly, it even protects creditors.[36] Although it is primarily a risk management and corporate governance tool,[37] it is usually understood as a creditor protection mechanism – or a failed creditor protection mechanism (see below). However, the legal capital regime cannot be understood from the perspective of creditor protection only.

Legal capital regime v minimum capital regime v leverage ratio. A legal capital regime can be distinguished from a mere minimum capital regime such as the Basel II framework, and from a leverage ratio regime such as that applied to banks in the US and in Switzerland.

The most fundamental difference between the legal capital regime applied to limited-liability companies in some countries and the minimum capital regime applied to financial institutions relates to corporate governance. Whereas the legal capital regime consists to a large extent of corporate governance rules, the minimum capital regime only lays down constraints on governance.[38] It is a regime that must be complied with, but the regime says nothing about corporate governance issues such as internal decision-making.

Unlike the legal capital regime, the minimum capital regime is typically designed to protect the financial infrastructure. On the other hand, even creditors, shareholders, and the firm may benefit from the mitigation of corporate risk and a reduction of systemic risk.

One of the failings of the Basel II minimum capital regime is that it does not prevent extreme leverage.[39] In the future, this could be cured by the introduction of a leverage ratio restriction designed to constrain the maximum degree to which

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34 BGHZ 90, 381 ("Beton- und Monierunion"); BGHZ 119, 191 (WestLB). See also Damnitz M, Degenhardt J, Faktische Geschäftsführung und kapitalersetzende (Bank-)Darlehen bei der AG, Wertpapier-Mitteilungen 31/2005 pp 583–591.

35 See Obergericht des Kantons Zürich, judgment of 19.1.1993; BGE, judgment of 2.3.2006, 5C.230/2005. For an introduction, see Stöckli U, Das kapitalersetzende Darlehen im Konkurs einer Aktiengesellschaft, Der Schweizer Treuhänder 2007/9 pp 662–666.

36 See also Arbeitskreis Bilanzrecht der Hochschlullehrer Rechtswissenschaft (AKBHR), BB 2002 p 2375, cited in Pellens B, Sellhorn T, Zukunft des bilanziellen Kapitalschutzes. In: Lutter M (ed), Das Kapital der Aktiengesellschaft in Europa, ZGR, Sonderheft 17. De Gruyter Recht, Berlin (2006) p 459.

37 See also Booth RA, Capital Requirements in United States Corporation Law. In: Lutter M (ed), Das Kapital der Aktiengesellschaft in Europa, ZGR, Sonderheft 17. De Gruyter Recht, Berlin (2006) p 720.

38 For the distinction between governance and constraint on governance, see Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005) Chapter 2.

39 Mewling and puking, The Economist, October 2008: "A rule change in 2004, which allowed the Wall Street firms to use the new calculations, showed that they continued to be well capitalised on a risk-adjusted basis even as they drove their absolute levels of leverage sky-high … For three of the five broker-dealers, that had fatal consequences."

a bank can leverage its equity capital base. (a) In the US, the Federal Deposit Insurance Corporation (FDIC) insists on maintaining a leverage ratio restriction (an additional risk-independent capital requirement that is proportional to the size of banks' assets). The introduction of a leverage ratio is not incompatible with the Basel I and Basel II frameworks. US regulators have proposed a leverage ratio even for international use. (b) In 2008, Swiss regulators decided to introduce a simple leverage ratio which does not allow for any risk-weighting of assets. This was partly because of the extreme leverage of the largest Swiss banks. In 2008, the two big Swiss banks had an average level of indebtedness of 97% (97 Swiss francs of borrowed capital for every three francs of equity). (c) In 2009, the German Ministry of Finance published a proposal for an act requiring the regular disclosure of the leverage ratio.[40] (d) According to the Turner Review of global banking regulation published by the FSA in 2009, a maximum gross leverage ratio should be introduced as a backstop discipline against excessive growth in absolute balance sheet size.[41]

The effect of both a minimum capital regime and a leverage ratio regime nevertheless depends not only the capital requirements or ratio (x%) but also on how they are calculated (x% of what). Where the minimum capital requirements and the leverage ratio are determined on the basis of an entity's balance sheet, the entity can have an incentive to use off-balance sheet constructions such as conduits and SPVs.

Legal capital regime v equity-insolvency test in the US. In the US, shareholders are typically protected by disclosure obligations. Creditors are often protected by equity-insolvency tests based on the Model Business Corporation Act (MBCA) and rules on fraudulent transfers based on the Uniform Fraudulent Transfer Act. The exact contents of creditor protection depend on the governing state law.[42] For more than a century, minimal statutory regulation has given borrowers and lenders an incentive to use covenants.[43]

The equity-insolvency tests mean that after a distribution, the corporation must be able to pay its debts as they become due in the usual course of business (MCBA § 6.40(c)).[44] In applying the § MCBA 6.40(c) equity-insolvency tests, the board may use the fair values rather than the accounting values of assets and liabilities.[45]

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[40] Referentenentwurf eines Gesetzes zur Stärkung der Finanzmarkt- und der Versicherungsaufsicht, March 2009.

[41] FSA, The Turner Review. A regulatory response to the global banking crisis (March 2009) pp 7, 54, and 67.

[42] For an introduction to creditor protection under Delaware law, See, for example, Fleischer H, Gläubigerschutz im Recht der Delaware corporation, RIW 2005 pp 92–97.

[43] See Bratton WW, Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process, EBOLR 7 (2006) pp 39–87.

[44] MCBA § 6.40(c): "No distribution may be made if, after giving its effect: (1) the corporation would not be able to pay its debts as they become due in the usual course of business; or (2) the corporation's total assets would be less than the sum of its liabilities ..." Distributions have been defined in MBCA § 1.40(6).

[45] MBCA § 6.40(d).

If adopted, the provisions of the Uniform Fraudulent Transfer Act enable a creditor to avoid a transfer or obligation for inadequate consideration under one of the following conditions: (1) the debtor was left by the transfer or obligation with unreasonably small assets for a transaction or the business in which he was engaged; (2) the debtor intended to incur, or believed that he would incur, more debts than he would be able to pay; or (3) the debtor was insolvent at the time or as a result of the transfer or obligation.

The lack of a legal capital regime is complemented by the lack of legal rules that vest decision-making powers in shareholders. The distribution of power between different corporate bodies is typically based on the company's statutes. As a rule, the board has plenty of discretion and shareholders have little formal power to intervene in corporate decisions.[46] For example, shareholders typically do not have any pre-emptive rights under company law rules "except to the extent articles of incorporation so provide",[47] and the board is free to make distributions to shareholders "subject to restriction by the articles of incorporation and [the equity-insolvency test]".[48]

One of the most important differences between the European legal capital regime and the US equity-insolvency test regime thus relates to corporate governance. Under a legal capital regime, legal capital transactions must typically be authorised by shareholders in general meeting ex ante. A legal capital regime is one of the ways to separate decision management and decision control and is staggered. Under an equity-insolvency test regime, transactions will typically be constrained by the test but not by any veto rights vested in the general meeting, unless their consent is required on other grounds (for example, consent might be required for large transactions such as takeovers on other grounds). An equity-insolvency test regime is less staggered ex ante. It is typically complemented by rules on shareholders' and board members' personal liability ex post.[49] Whereas the European capital regime leads to better monitoring of decisions under company laws ex ante, the US equity-insolvency test means less monitoring under company laws ex ante complemented by the threat of sanctions applied under insolvency laws ex post.[50]

A further difference is that a legal capital regime that focuses on distributions to shareholders is less likely to restrict payments that are either not made to share-

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[46] See Bebchuk LA, The Case for Increasing Shareholder Power, Harv L R 118 (2005) pp 833–914.

[47] MCBA § 6.30(a).

[48] MCBA § 6.40(a).

[49] See Lutter M, Das (feste Grund-)Kapital der Aktiengesellschaft in Europa, Zusammenfassung der Überlegungen des Arbeitskreises „Kapital in Europa". In: Lutter M (ed), Das Kapital der Aktiengesellschaft in Europa, ZGR, Sonderheft 17. De Gruyter Recht, Berlin (2006) p 12; Veil R, Kapitalerhaltung. Das System der Kapitalrichtlinie versus situative Ausschüttungssperren. In: Lutter M (ed), *op cit*, p 106; Engert A, Kapitalgesellschaften ohne gesetzliches Kapital: Lehren aus dem US-amerikanischen Recht. In: Lutter M (ed), *op cit*, pp 769–784.

[50] Engert A, Kapitalgesellschaften ohne gesetzliches Kapital: Lehren aus dem US-amerikanischen Recht. In: Lutter M (ed), *op cit*, p 746.

holders or not regarded as distributions. If designed properly, an equity-insolvency test can thus cover a broader range of transactions.

Legal capital regime v contracts. From the perspective of the company's shareholders, no contracts with creditors' can replace a legal capital regime as a corporate governance tool. Whether contracts can replace a legal capital regime as a creditor protection mechanism is another matter. Typically, contracts can replace a legal capital regime if the company has only one contract party (or only one syndicated block of contract parties) and both parties can agree on the terms of the contract. Where the company has many independent contract parties, the situation is less clear. The situation of creditors becomes even weaker where they are involuntary creditors who do not agree on anything rather than voluntary creditors who, in principle, could agree on something.[51]

5.4 The Legal Capital Regime Under EU Company Law

The US and the Member States of the EU have adopted radically different approaches to legal capital as far as large companies are concerned. Community law provides for a legal capital regime for public limited-liability companies. This regime consists of core corporate governance rules as well as minimum capital rules. When adopted, the SPE Regulation will introduce a flexible company form for private-limited liability companies. The proposed SPE Regulation contains a flexible legal capital regime. In the US, the lack of a legal capital regime is mirrored by shareholders lacking effective veto rights.[52]

General remarks. In a broad sense, the European legal capital regime for public limited-liability companies (for the proposed legal capital regime for SPEs, see below) consists of: the existence of legal capital;[53] statutory minimum capital requirements; restrictions on the use and distribution of legal capital; rules prohibiting circumvention; as well as shareholders' decision rights, pre-emptive rights and rights to information.[54]

The legal capital regime for public limited-liability companies is based on the Second Company Law Directive. It is complemented by the Merger Directives and the Directive on divisions (section 10.4). Member States are not required to impose any legal capital rules on private limited-liability companies or other en-

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[51] See, for example, Peter Mankowski, Reicht das Vertragsrecht für einen angemessenen Schutz der Gesellschaftsgläubiger und ihrer Interessen aus? In: Lutter M (ed), *op cit*, pp 488–507.

[52] See Bebchuk LA, The Case for Increasing Shareholder Power, Harv L R 118 (2005) pp 833–914.

[53] See Article 2 of Directive 77/91/EEC (Second Company Law Directive). See also Articles 7, 8(1), and 6(1).

[54] Compare Enriques L, Macey JR, Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules, Cornell L R 86 (2001) pp 1174–1183; Werlauff E, EU Company Law. Second Edition. DJØF Publishing, Copenhagen (2003); Schwarz GC, Europäisches Gesellschaftsrecht. Nomos, Baden-Baden (2000).

terprise forms not covered by the Second Directive.[55] Legal capital regimes are nevertheless characteristic of continental European company laws in general.

The legal capital regime contains core corporate governance rules common to all public limited-liability companies incorporated in the EU. The stated purpose of the general legal capital regime is to protect weak shareholders and creditors. The traditional justification for minimum capital rules is that compliance with such rules is the price that shareholders must pay to obtain the benefits of limited liability. There are no such mandatory rules in the law of partnerships and limited partnerships. The legal capital regime is nevertheless much more than just minimum capital requirements. Decision rights vested in the general meeting are an important aspect of the European legal capital regime. They are believed to be necessary for two reasons: the protection of minority shareholders and the enforcement of the principle of equal treatment of shareholders in the same position.[56]

Forms of legal capital. The forms of "legal capital" under EU company law range from share capital to certain other asset classes in the balance sheet. The required or permitted classes of legal capital must be based on the articles of association (the statutes or the instrument of incorporation of the company) and/or filed with the trade register.

- The company can have *authorised capital*.[57] When a company is set up or its articles of association amended, the shareholders can authorise the minimum and maximum amount of *share capital*. If each share is a share of the aggregate share capital, the shareholders can authorise the minimum and maximum number of shares that can be issued.
- The company must have *subscribed capital*.[58] The amount of subscribed capital should range between the minimum authorised share capital and the maximum authorised share capital.[59] Where the company has not authorised a minimum and maximum amount of share capital, the subscribed capital and the share capital should be the same.
- The shares of the company can have a *nominal value*.[60] Alternatively, the company can have shares without a nominal value.[61]

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[55] For German law, see MoMiG-RegE of 23 May 2007 (der Regierungsentwurf des Gesetzes zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen) which proposed the reduction of minimum share capital requirement for a limited-liability company from € 25,000 (GmbH) to € 1 (Unternehmergesellschaft).

[56] See, for example, recital 5 of Directive 77/91/EEC (Second Company Law Directive).

[57] Article 2(c) of Directive 77/91/EEC (Second Company Law Directive).

[58] Articles 2(c) and 3(g) of Directive 77/91/EEC (Second Company Law Directive).

[59] See also Article 34 of Directive 77/91/EEC (Second Company Law Directive).

[60] Article 3(b) of Directive 77/91/EEC (Second Company Law Directive). See also Article 3(h).

[61] Article 3(c) of Directive 77/91/EEC (Second Company Law Directive). See also Article 3(h).

Excursion: Why increase or reduce share capital? The distribution of subscribed capital is subject to restrictions. A company can thus increase the equity nature of its assets by converting distributable assets into undistributable assets. Where the shares of the company have a nominal value, the company cannot issue new shares without increasing the amount of such assets. The company can also reduce share capital. In principle, the company may want to convert undistributable assets into assets that may be regarded as distributable. If the company has made a loss and part of the company's share capital has been wiped out, the board may have to restore the company's balance sheet position or commence bankruptcy or liquidation proceedings; the company may therefore have to reduce its share capital by cancelling part of it without making any payment to its shareholders.[62]

Fixed minimum capital. The Second Directive also lays down some fixed minimum capital requirements. As said above, fixed minimum capital requirements are not a necessary ingredient of a legal capital regime. Creditors can be protected even in other ways. This became clear in Case C-212/97 *Centros*, in which the freedom of establishment prevailed over the application of the higher minimum capital requirements of the host country and there was no justification to apply the laws of the host country on public policy grounds. The fixed minimum capital requirements are as follows:

- The minimum legal capital of a public limited-liability company must be at least €25,000.[63] This requirement does not apply to private limited-liability companies, as they do not fall within the scope of the Directive.[64]
- The general minimum capital requirement is complemented by sector-specific capital requirements such as initial capital requirements for investment firms.[65]

An investment firm must have an initial minimum capital of €730,000 unless the Capital Requirements Directive permits a lower initial capital.[66] For example, a minimum initial capital requirement of €125,000 is imposed where the investment firm "does not deal in any financial instruments for its own account or underwrite issues of financial instruments on a firm commitment basis" but "holds clients' money and/or securities" and "offers one or more of the following services: (a) the reception and transmission of investors' orders for financial instruments; (b) the execution of investors' orders for financial instruments; or (c) the management of individual portfolios of investments in financial instruments".[67]

[62] See Article 33 of Directive 77/91/EEC (Second Company Law Directive).

[63] Article 6(1) of Directive 77/91/EEC (Second Company Law Directive).

[64] In England, section 763 of the Companies Act 2006 lays down minimum share capital requirements for public limited-liability companies. Sections 542, 547 and 548 of the Companies Act 2006 provide for share capital but do not lay down any minimum share capital requirements for private limited-liability companies.

[65] See Article 67 of Directive 2004/39/EC (MiFID).

[66] Article 9 of Directive 2006/49/EC (Capital Requirements Directive). For critical views, see Moloney N, EC Securities Law. OUP, Oxford (2008) pp 462–463.

[67] Article 5(1) of Directive 2006/49/EC (Capital Requirements Directive).

Restrictions on use and distribution – main rules. The fixed minimum capital requirements are complemented by other restrictions on the use and distribution of capital.

- The main rule is that, except for cases of reductions of subscribed capital, no *distribution* to shareholders may be made when on the closing date of the last financial year the *net assets* as set out in the company's *annual accounts* are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes.[68]
- The assets and liabilities are therefore determined on the basis of the relevant accounting provisions. The existence of a distribution is not. In the light of the proposal for the SPE Regulation, the term "distribution" could mean "any financial benefit derived directly or indirectly from [the company] by a shareholder, in relation to the shares held by him, including any transfer of money or property, as well as the incurring of debt".
- Furthermore, the Second Directive provides for the *equal treatment* of shareholders who are in the same position (for example, this will restrict the use of greenmail and poison pills; see sections 18.8 and 18.9).[69]

Prevention of circumvention. The Second Directive contains many provisions on circumvention. The most important provisions include the following:

- There is prohibition of issues under par. To ensure that a company receives full consideration for its subscribed capital, the Second Directive states that shares "may not be issued at a price lower than their nominal value, or, where there is no nominal value, their accountable par".[70]
- The subscribed capital may be formed only of assets capable of economic assessment. An undertaking to perform work or supply services may not form part of these assets.[71]
- Subject to the provisions relating to the reduction of subscribed capital, the shareholders may not be released from the obligation to pay up their contributions.[72]
- Shares issued for a consideration must be paid up at the time the company is incorporated or is authorised to commence business at not less than 25% of their nominal value or, in the absence of a nominal value, their accountable par.[73]

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[68] Article 15(1)(a) of Directive 77/91/EEC (Second Company Law Directive).
[69] Article 42 of Directive 77/91/EEC (Second Company Law Directive).
[70] Article 8(1) of Directive 77/91/EEC (Second Company Law Directive).
[71] Article 7 of Directive 77/91/EEC (Second Company Law Directive).
[72] Article 12 of Directive 77/91/EEC (Second Company Law Directive).
[73] Article 9(1) of Directive 77/91/EEC (Second Company Law Directive).

- However, where shares are issued for a consideration other than in cash at the time the company is incorporated or is authorised to commence business, the consideration must be transferred in full within five years of that time.[74]
- The shares of a company may not be subscribed for by the company itself.[75]
- Where the laws of a Member State permit a company to acquire its own shares, the acquisitions must not have the effect of reducing the net assets below the amount mentioned in the main rule on distributions (the earlier maximum limit of 10% of the subscribed capital is now optional).[76]
- Any distribution made contrary to the main rule must be returned by shareholders who have received it if the company proves that these shareholders knew of the irregularity of the distributions made to them, or could not in view of the circumstances have been unaware of it.[77]
- A company may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party.[78]
- It is also worth noting that the Second Directive does not provide for any exemption for distributions made to the parent company in a company group. This may influence the French *Rozenblum* doctrine as well provisions of the German Aktiengesetz on "group law" (Konzernrecht).[79]

Restrictions on use and distribution: decision-making. There is increased separation of control and management. The general meeting has a veto right in transactions that typically increase or reduce legal capital.

- Generally, shareholders have traditionally been protected by mandatory provisions of company law in continental Europe. According to continental European company laws and the Second Directive, existing shareholders have preemptive rights.[80]
- The Second Directive provides that the general meeting decides on: any increase in (legal) capital;[81] the authorisation of a company body to decide on an increase in the subscribed capital;[82] the withdrawal of shareholders' right of preemption;[83] the authorisation of a company body to decide on withdrawal of sha-

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74 Article 9(2) of Directive 77/91/EEC (Second Company Law Directive).
75 Article 18(1) of Directive 77/91/EEC (Second Company Law Directive).
76 Article 19(1) of Directive 77/91/EEC (Second Company Law Directive) (as amended by Directive 2006/68/EC).
77 Article 16 of Directive 77/91/EEC (Second Company Law Directive).
78 Article 23(1)(c) of Directive 77/91/EEC (Second Company Law Directive).
79 See Fleischer H, Verdeckte Gewinnausschüttung und Kapitalschutz im Europäischen Gesellschaftsrecht. In: Lutter M (ed), *op cit*, pp 130–131; Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 47–48.
80 Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).
81 Article 25(1) of Directive 77/91/EEC (Second Company Law Directive). For English law, see section 617 of the Companies Act 2006.
82 Article 25(2) of Directive 77/91/EEC (Second Company Law Directive).
83 Article 29(4) of Directive 77/91/EEC (Second Company Law Directive).

reholders right of pre-emption;[84] the authorisation to acquire own shares;[85] reduction in the subscribed capital;[86] the reduction of subscribed capital by compulsory withdrawal of shares;[87] and reduction in the subscribed capital by the withdrawal of shares acquired by the company itself.[88]

- Where there are several classes of shares, the decision by the general meeting is in many cases subject to a separate vote for each class of shareholder whose rights are affected by the transaction. Such rules apply to increase in capital,[89] reduction in the subscribed capital,[90] as well as redemption of the subscribed capital or its reduction by withdrawal of shares.[91] Depending on the governing law, they may also influence the exercise of pre-emptive rights.[92]
- The change of legal capital such as share capital may require a change of articles of assocation and may, depending on the law that governs the entity, be subject to further restrictions.[93] The European legal capital regime does not "prejudice the provisions of Member States on competence and procedure relating to the modification of the statutes or of the instrument of incorporation".[94]
- The decision rights are complemented by information rights. There are particular rules on the waiving of pre-emptive rights, on consideration other than cash, and on share buybacks. (a) When the consideration comes in a form other than cash, the Second Directive requires "one or more independent experts appointed or approved by an administrative or judicial authority" to create a report. The report must describe the assets and the methods of valuation, and indicate whether the resulting valuations "correspond at least to the number and nominal value, or where there is no nominal value, to the accountable par and, where appropriate, to the premium on the shares to be issued for them".[95] (b) Before the right of pre-emption is restricted or withdrawn by decision of the general meeting, the "administrative or management body shall be required to present to such a meeting a written report indicating the reasons for restriction or withdrawal of the right of pre-emption, and justifying the proposed issue price".[96] (c) Member States may subject share buybacks to the condition that the company complies with appropriate reporting and notification require-

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84 Article 29(5) of Directive 77/91/EEC (Second Company Law Directive).
85 Article 19(1) of Directive 77/91/EEC (Second Company Law Directive).
86 Article 30 of Directive 77/91/EEC (Second Company Law Directive). See also Article 32.
87 Article 36 of Directive 77/91/EEC (Second Company Law Directive).
88 Article 37 of Directive 77/91/EEC (Second Company Law Directive).
89 Article 25(3) of Directive 77/91/EEC (Second Company Law Directive).
90 Article 31 of Directive 77/91/EEC (Second Company Law Directive).
91 Article 38 of Directive 77/91/EEC (Second Company Law Directive).
92 Article 29(2)(b) of Directive 77/91/EEC (Second Company Law Directive).
93 For English law, see section 617 of the Companies Act 2006.
94 Article 14 of Directive 77/91/EEC (Second Company Law Directive).
95 Article 10 of Directive 77/91/EEC (Second Company Law Directive).
96 Article 29(4) of Directive 77/91/EEC (Second Company Law Directive).

ments.[97] Furthermore, compliance with additional reporting and notification requirements is necessary in order to avoid insider dealing and market abuse (section 5.9.7 and Chapter 19).[98]

- In the case of a serious loss of the subscribed capital, a general meeting must be called to consider whether the company should be wound up or any other measures taken.[99] This provision does not require a company either to wind itself up or to take other measures. Rather, the only requirement is that the company let shareholders discuss the possible alternatives, including the possibility of not taking any action. This provision also applies, when losses put the company below the statutory minimum capital requirement.

Excursion: capital requirements in US corporation law. Even in the US, there have been legal capital rules covering areas such as par value and dilution of stock.

According to *Booth*, "it is not clear that the rules relating to par value and watered stock were intended to protect creditors. Rather, they may have been intended to assure equal treatment among subscribing stockholders, a function that was largely supplanted by the federal Securities Act of 1933."[100] However, legal capital rules have "lost virtually all of their significance and force for stockholders and creditors alike" and creditors rely primarily on negotiated contractual protections.[101]

In the US, corporation law is state law. As regards internal decision-making of the company, the board typically can be given large powers under the company's articles and shareholders have weaker legal powers than in continental Europe.[102] The legal capital rules vary widely from state to state. There are essentially five models in common use:[103]

- The 1950 Model Business Corporation Act (MBCA) followed an earned surplus rule (there is a par value for shares, there are legal capital accounts, and a corporation may not invade stated capital to make distributions to stockholders).

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[97] Article 19(1) of Directive 77/91/EEC (Second Company Law Directive) (as amended by Directive 2006/68/EC).

[98] Article 8 of Directive 2003/6/EC (Directive on market abuse); Regulation 2273/2003.

[99] Article 17(1) of Directive 77/91/EEC (Second Company Law Directive). See also Article 17(2): "The amount of a loss deemed to be serious within the meaning of paragraph 1 may not be set by the laws of Member States at a figure higher than half the subscribed capital."

[100] Booth RA, Capital Requirements in United States Corporation Law. In: Lutter M (ed), Das Kapital der Aktiengesellschaft in Europa, ZGR, Sonderheft 17. De Gruyter Recht, Berlin (2006) pp 720.

[101] Booth RA, *op cit*, p 742.

[102] See, for example, Engert A, Kapitalgesellschaften ohne gesetzliches Kapital: Lehren aus dem US-amerikanischen Recht. In: Lutter M (ed), *op cit*, p 761.

[103] According to Booth RA, *op cit*, pp 743–798.

- The 1984 Revised Model Business Corporation Act (RMBCA) follows a simple balance sheet rule (there is a solvency test and a balance sheet test according to which assets must be at least equal to liabilities after a distribution).
- Both Delaware and New York follow simple surplus rules (shares have a par value; a corporation may pay dividends to the extent that assets exceed liabilities plus stated capital).
- California follows a percentage test (no par value, two alternative tests, a corporation may pay a dividend to the extent of retained earnings or to the extent that remaining assets will equal at least 125% of liabilities and current assets at least equal current liabilities after the dividend).
- Massachusetts has no balance sheet rules whatsoever.

Insolvency rule in the EU? The US-type equity-insolvency test is not part of Community law but Member States are free to adopt it. For example, the Swedish Company Act and the Finnish Company Act lay down a legal capital regime complemented by an equity-insolvency test.[104] A narrower equity-insolvency test complements the traditional legal capital regime under the German GmbHG (as amended by the MoMiG).[105]

Benefits of the European legal capital regime. The European legal capital regime for public limited-liability companies brings many benefits.[106]

- Approximation of laws. The European legal capital regime belongs to the most important ways to approximate Member States' corporate governance rules in the area of company law.
- Separation of management and control. One of the main reasons for adopting a legal capital regime is to increase separation of management and control through shareholders' increased veto rights and information rights.
- Transparency. The purpose of European and financial reporting standards is to increase transparency and the reliability of financial information. The legal capital regime can further improve the quality of financial reporting by giving shareholders better incentives to monitor the balance sheet. Increased monitoring should increase transparency and therefore also the reliability of financial reporting. Many are nevertheless of the opinion that the quality of financial information is bound to be compromised if the amount of distributable assets depends on the balance sheet.
- Reduction of non-controlling shareholders' perceived risk. Shareholders' increased veto rights and information rights can reduce non-controlling share-

[104] Chapter 13 § 2 of the Finnish Company Act of 2006; Chapter 17 § 3 of the Swedish Company Act of 2005.

[105] § 64 GmbHG. For the relationship between the balance sheet and restrictions on distributions, see Joachim Hennrichs, IFRS und Mittelstand – Auswirkungen der GmbH-Reform und Zukunft der Kapitalerhaltung, ZGR 2008 pp 361–380.

[106] See also Lutter M (ed), Legal Capital in Europe. ECFLR/Special Volume 1, November 2006; Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) p 182.

holders' perceived risk. The quality of investor protection is generally assumed to have a favourable effect on the price that investors are prepared to pay for shares and on the firm's funding costs.

- Management of information (signalling and screening). In a compliance culture, mandatory provisions of law setting out both substantive constraints and effective sanctions for their breach can reduce the risk of a market for "lemons" by signalling to external investors that a company will be likely to comply with a certain standard and that compliance has been verified by members of the corporate bodies of the company, its statutory auditors, at least some of its shareholders, or – in some cases – supervisory authorities.[107] This benefit is not limited to the legal capital regime; other mandatory requirements such as the Basel II or the equity-insolvency test work in the same way.
- Protection of creditors. Indirectly, creditors benefit from increased monitoring and better governance. Like debt covenants, the staggered constraints on distributions ex ante can increase time required for distributions, provide information to creditors, act as an early warning system, and reduce creditors' perceived risk. This could in principle influence the pricing of claims and the cost of debt funding.

On the other hand, the legal capital regime has its failings. A legal capital regime typically focuses on distributions to shareholders and transactions involving shares but fails to cover business transactions in a general manner. A complementing equity-insolvency test might help to solve this problem (as in Swedish and Finnish company law or the German GmbHG as amended by the MoMiG). Instead of an equity-insolvency test, financial institutions are subject to minimum capital requirements based on their risk exposure.

IFRS can be combined with a legal capital regime. The amount of distributable assets can be determined even on the basis of IFRS.[108] However, the primary purpose of IFRS is to "provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions"[109] and not to provide a basis for any other investor protection regime. For example, fair-value accounting can increase the volatility of the amounts of distributable assets. A complementing equity-insolvency test or other constraints restrictions might mitigate problems caused by IFRS and fair-value accounting.[110]

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[107] Kuhner C, Zur Zukunft der Kapitalerhaltung durch bilanzielle Ausschüttungssperren im Gesellschaftsrecht der Staaten Europas, ZGR 2005 pp 763.

[108] Pellens B, Sellhorn T, Zukunft des bilanziellen Kapitalschutzes. In: Lutter M (ed), Das Kapital der Aktiengesellschaft in Europa, ZGR, Sonderheft 17. De Gruyter Recht, Berlin (2006) p 460.

[109] Framework F.12. See also IAS 1.13.

[110] Lutter M, Das (feste Grund-)Kapital der Aktiengesellschaft in Europa, Zusammenfassung der Überlegungen des Arbeitskreises „Kapital in Europa". In: Lutter M (ed), *op cit*, pp 10–12. Pellens B, Sellhorn T, Zukunft des bilanziellen Kapitalschutzes. In: Lutter M (ed), *op cit*, pp 460–461 and 467–468.

Furthermore, the existence or absence of the legal capital regime does not change the fact that certain controlling shareholders may always have incentives to manipulate the balance sheet and an opportunity to expropriate the company's assets.[111] It can therefore be difficult to design a legal capital regime or an equity-insolvency test that would adequately protect creditors when the entity has a controlling shareholder. Typically, creditors can be protected by the personal liability of the controlling shareholder (see Volume II). A legal capital regime will nevertheless make it easier for non-controlling shareholders to invoke breach of mandatory provisions of company law in the event of expropriation of the company's assets.

Interests of the firm. Both a legal capital regime and a statutory equity-insolvency test can help to protect the interests of the firm.

A legal capital regime is designed to signal a lower risk particularly to share investors and to reduce the funding costs of the firm. All parties have knowledge about the contents of a legal capital regime as it is based on the law.

Furthermore, absolute statutory constraints on distributions to shareholders can protect the firm against expropriation by shareholders as they can make it easier for the board and management to resist shareholders' claims for bigger distributions in a company with dispersed ownership. Without absolute statutory constraints, it would be easier for short-term financial shareholders who have obtained control of the company to give members of the company's board an incentive to distribute the company's assets to shareholders contrary to the long-term interests of the firm. In other words, it would be easier for the board to let the controlling shareholder "loot" the firm. In order to be effective in a company with a controlling shareholder and weak non-controlling shareholders, the absolute statutory constraints should also prevent circumvention (be "watertight"), because otherwise they would only channel actions into particular forms.[112]

A further benefit is that, if effective, absolute statutory constraints on the distribution of assets to shareholders can help the firm to defend itself against hostile takeovers by making refinancing more difficult. Again, absolute statutory constraints cannot prevent the merger of the takeover vehicle and the target company (section 20.4).

A legal capital regime should preferably be complemented by an equity-insolvency test to make the regime more "watertight" and to cover general business transactions typically not covered by a legal capital regime.

Those aspects can be contrasted with the use of mere debt covenants. (a) Debt covenants are designed to protect particular debt investors under that particular debt agreement. They are not designed to protect shareholders. (b) Debt investors and equity investors generally have less information about debt covenants in other agreements than their own. (c) Although debt covenants can be enforced against the company itself, they cannot be enforced against members of its corporate bod-

[111] For German law, see Hommelhoff P, Modernisiertes HGB-Bilanzrecht im Wettbewerb der Regelungssysteme. Konzeptionelle Bemerkungen aus Anlass des RefE BilMoG, ZGR 2008 p 253.

[112] See Armour J, Legal Capital: an Outdated Concept? EBOLR 7 (2006) pp 5–27.

ies, managers, or shareholders. Members of the firm's corporate bodies may choose to default on a debt agreement without becoming personally liable to any party, if they believe it is in the interests of the firm to do so.

Interests of creditors. Creditors can benefit to the extent that the legal capital regime reduces the risk of a deterioration of the company's creditworthiness or the risk of the company becoming insolvent. However, the legal capital regime does not prevent the company from making bad business choices. Creditors benefit only indirectly from the staggered legal constraints on the distribution and use of assets. In addition to the disclosure of financial information, the most important provisions that protect creditors in the Member States of the EU include provisions of national company and insolvency laws that make a company's organ members personally liable to creditors for damage caused by breach of duty and make parties who obtained funds from the company liable to return those funds to the company or its creditors. Where such obligations require breach of provisions of company law or breach of duty of care, the existence of such statutory staggered constraints can make it easier for creditors to sue.[113]

Critical views on the European legal capital regime. Neither fixed legal capital nor a general legal capital regime are traditional ingredients of the company laws of common law countries. Fixed legal capital had to be incorporated into English law for public limited-liability companies by virtue of the Second Directive.

Against this background, it becomes more understandable why critics believe that adopting an insolvency rule based on the US Revised Model Business Corporation Act would be a flexible way to protect creditors and why the European legal capital regime has been heavily critisised particularly in common law countries.

It is nevertheless worth noting that the critics of the European legal capital regime regard it as a *failed creditor protector regime* but fail to recognise its important role in *corporate governance*. Furthermore, the critics do not compare *comparable things*, that is, things that serve the same *function*. As regards the protection of creditors in the US, the equity-insolvency test is complemented by increased liability under insolvency laws and should not be studied separately. The equity-insolvency test clearly does not address the issue of allocation of power in the company at all and is therefore not comparable with the regulation of a company's internal decision-making in Europe. The list of the failings of legal capital as a creditor protection device is nevertheless very long.[114] The critics' main arguments are as follows:

- Inflexibility and cost. It has been argued that a legal capital regime makes the financial structures of companies inflexible, burdens them with cumbersome

[113] For the liability of directors as a creditor protection mechanism, see Mülbert PO, A Synthetic View of Different Concepts of Creditor Protection - Or a High-Level Framework for Corporate Creditor Protection (February 2006). ECGI - Law Working Paper No. 60/2006.

[114] See, for example, Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 181–182.

procedures, and forces them to pay for expert reports and legal advice.[115] There are also indirect costs caused by the time required for all necessary corporate action, independent expert reports and other formalities.

- Other ways to protect creditors. In addition, it has been argued that legal capital is no longer an appropriate concept to employ in safeguarding the interests of creditors.[116] According to this view, creditors can contract for core payment terms (section 3.4.2) and credit enhancements (Volume II). The interest rate that lenders charge is also compensation for the risk that borrowers will misbehave. Many say that covenants can restrict the freedom of corporate borrowers to distribute assets to shareholders and that weak or involuntary creditors can take advantage of those sophisticated lenders who impose a restriction on distributions to shareholders (covenants) and who monitor the borrower to ensure compliance. The decrease in the company's risk of insolvency will benefit all creditors.[117]
- Meaningless minimum capital requirement. The minimum initial capital requirement is often regarded as meaningless, because it is unrelated to the debt that a company may incur and to the sorts of business activities that a company may pursue.[118]
- Channelling of actions. One of the problems associated with a legal capital regime is that it may become a means for channelling actions into particular forms if it is not watertight.[119] The regime should therefore prohibit certain specific distributions and generally distributions with a similar effect.

The British Accounting Standards Board (ASB) and the Company Law Centre at the British Institute of International and Comparative Law (BIICL) initiated a study of the benefits of the European legal capital regime by a group of experts led by Jonathan Rickford. The result of the study was that legal capital was costly and superfluous and that the Second Directive should be repealed.[120] The British government has adopted this view and wants the Commission to act accordingly.

Modernisation of the European legal capital regime. The European legal capital regime was to some extent diluted by the adoption of Directive 2006/68/EC amending the Second Company Law Directive.

The purpose of Directive 2006/68/EC was to contribute to the deregulation and liberalisation of the legal capital regime. The Directive gave Member States more

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[115] Enriques L, Macey JR, Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules, Cornell L R 86 (2001) pp 1184–1185.

[116] Armour J, Legal Capital: an Outdated Concept? EBOLR 7 (2006) pp 5–27.

[117] See Enriques L, Macey JR, *op cit*, p 1172.

[118] *Ibid*, pp 1185–1186.

[119] Armour J, Legal Capital: an Outdated Concept? EBOLR 7 (2006) pp 5–27.

[120] See Rickford J, Reforming Capital: An Introductory Note, EBLR 15 (2004) pp 1029–1030. See also European Shadow Financial Regulatory Committee (ESFRC), Statement No. 21. Deregulating Corporate Finance in Europe, Financial Markets and Portfolio Management 19 (2005) pp 407–409: "… the ESFRC recommends to repeal the Second Directive as a whole rather than engaging in piecemeal efforts to modify some of its provisions."

discretion. (a) Member States were made able to permit public limited-liability companies to allot shares for consideration other than in cash without requiring them to obtain a special expert valuation in cases in which there is a clear point of reference for the valuation of such consideration.[121] (b) Member States can allow public limited-liability companies to acquire their own shares up to the limit of the company's distributable reserves (the upper limit of 10% was thus abolished). The period for which such an acquisition may be authorised by the general meeting was increased (from 18 months to five years).[122] (c) Member States were made able to permit public limited liability companies to grant financial assistance with a view to the acquisition of their shares by a third party up to the limit of the company's distributable reserves.[123]

Directive 2006/68/EC is not a departure from the fundamental objectives of the legal designed capital regime. In Europe, the legal capital regime not only protects creditors. It plays an important role in corporate governance. However, it was indicated in the Directive that it is necessary to "proceed without delay to a general examination of the feasibility of alternatives to the capital maintenance regime which would adequately protect the interests of creditors and shareholders of a public limited liability company".[124]

Basically, Directive 2006/68/EC reflects an unfortunate change into Anglo-American thinking. Under continental European laws, the management of the firm is constrained by shareholders' pre-emptive and veto rights. Shareholders' rights and the governance structure of the company are expected to contribute to the long-term survival of the firm. The Anglo-American way of thinking is that shareholders should have weaker rights and that management should be constrained in other ways, in particular by disclosure and the capital market (see Volume I).

Legal capital regime for SPEs. The core components of a legal capital regime can be found even in the proposal for a SPE Regulation. The SPE Regulation provides for staggered constraints on the distribution or use of certain asset classes in the balance sheet. Those constraints are nevertheless less restrictive compared with the legal capital regime for public limited-liability companies.

First, the SPE Regulation requires the existence of *legal capital*. There must be capital divided into shares and that capital must be fully subscribed. The statutory minimum capital requirement is reduced to €1. The company can also have reserves according to its articles of association.

Second, the use and distribution of capital is *constrained* by the SPE Regulation and the articles of association. (a) The articles of association of an SPE will contain many provisions relating to capital and its use. The SPE Regulation lays down how articles of association can be amended. (b) Shareholders decide on increase of share capital, reduction of share capital, distribution to shareholders, and amendments to articles of association. (c) There are restrictions on the reduction of capital. (d) In addition, the SPE Regulation regulates distributions to sharehold-

[121] Recital 3 of Directive 2006/68/EC.
[122] Recital 4 of Directive 2006/68/EC.
[123] Recital 5 of Directive 2006/68/EC.
[124] Recital 2 of Directive 2006/68/EC.

ers: "… the SPE may, on the basis of a proposal of the management body, make a distribution to shareholders provided that, after the distribution, the assets of the SPE fully cover its liabilities. The SPE may not distribute those reserves that may not be distributed under its articles of association." (d) The articles of association can also require a solvency certificate before a distribution is made.

Third, the proposed SPE Regulation contains rules designed to prevent *circumvention*. Such rules include rules on the acquisition of the SPE's own shares and on the redemption of shares.

5.5 Strategic Choices

Equity and shareholders' capital raise fundamental questions of corporate strategy. The firm must answer four important questions: (1) What should be the mix of the firm's equity and debt? (2) How should the firm's equity be allocated between different classes of equity instruments? How much shareholders' capital should the company have? (3) What should be the shareholder base of the company? (4) Should the company's shares be privately-owned or traded on a regulated market?

Reasons to use equity. The use of equity brings many benefits but can have some drawbacks.

From a financial perspective, the core benefits are as follows: (a) Increasing equity reduces the risk of corporate failure in an economic downturn. (b) Increasing equity can improve the credit rating of the firm and decrease the cost of debt capital. (c) Issuing shares can generally give access to shareholders' ancillary services. (d) Issuing shares can sometimes enable the firm to purchase ancillary services and assets that it otherwise would not be able to purchase. For example: an entrepreneur may only want to sell his business to the firm if he becomes a large shareholder in the firm; a certain manager might only want to work for the firm if he is given shares and option rights; and an important supplier of branded goods might only want to export its goods to importers that it owns or controls.

The use of equity can nevertheless have some drawbacks: (a) Decreasing gearing can reduce return on equity. (b) If the company has a very low debt-to-equity ratio, debt does not force its managers to be effective. (c) Shareholders' contributions can be expensive, because shareholders expect a higher return or more benefits as a reward for higher risk. (d) Share capital is not as flexible as debt capital, because many relevant company law rules are mandatory. (e) It is more difficult for managers to decide on share capital transactions because many decisions on share capital must be decided on by shareholders in general meeting under mandatory company law rules. (f) Issuing more shares can dilute the holdings of existing shareholders and make shareholders object to new share issues.

Reasons for being privately-owned. In theory, a company whose shares are traded on a regulated market can have easier access to equity capital. In practice, however, almost all businesses in the world are privately-owned and only a small proportion of firms have gone public. The most important benefits of being privately-owned include flexibility and confidentiality.

A privately-owned business can choose from many enterprise forms. The choice of enterprise form affects the regulation of all corporate governance issues (for incorporation, see Volume I). For example, it affects the question of legal personality, limited liability, the transferability of shares, the duty to disclose information, and the making of payments to owners. The business can be owned by a sole trader. Other enterprise forms available to a privately-owned business can range from a partnership (partnership[125] or limited partnership[126]) to limited-liability companies (public limited-liability company[127] or private limited-liability company[128]).

A privately-owned business has more freedom to use its capital and return funds to owners even where it is a limited-liability company. It is particularly easy where the firm is a partnership.

This can be illustrated by private equity. Shares in a target company that has been taken over by a private equity fund will, after refinancing, usually be owned by a limited partnership. The limited partnership is either the sole shareholder, or the top managers of the target company have been given a block of shares in order to align their interests with those of the private equity fund. As there are no external minority shareholders claiming equivalent treatment or the furtherance of the long-term interests of the firm, it is easier to decide on distributions to owners. As the entity that owns shares in the target is a limited partnership, most questions can be based on contract between investors. It is therefore easy for the limited partnership to make distributions to investors. Private equity investors may have used a holding company with limited liability in order to reduce legal risk or for tax purposes.

A privately-owned business has few disclosure obligations compared with a listed company (see section 5.9).

Privately-owned companies and publicly-owned companies. A privately-owned company can stay private or go public, and a publicly-owned company can stay public or go private.

Depending on the governing law, going public may require changing the company form of the firm. Member States' company laws usually distinguish between two forms of limited-liability companies: those whose shares can be traded only privately and those whose shares can be traded on a stock exchange.[129] Legal rules regulating those two basic company forms can be found in two separate statutes (Aktiengesetz/AG and GmbH-Gesetz/GmbH) or the same statute (Companies Act 2006/ltd and plc).

[125] Developed from the societas.

[126] "Kommanditgesellschaften" developed from the commenda.

[127] Such as companies mentioned in Article 1(1) of Directive 77/91/EEC (Second Company Law Directive).

[128] Such as companies mentioned in Article 1 of Directive 68/151/EEC (First Company Law Directive).

[129] See Article 1 of Directive 77/91/EEC (Second Company Law Directive).

In addition, securities may not be admitted to trading on a regulated market in the EU unless particular listing conditions have been satisfied.[130] One of the key requirements is the consent of the competent authorities.[131]

Reasons for going public. The benefits and drawbacks of going public depend on the perspective. Controlling shareholders, managers, and the firm may have conflicting interests.

Controlling shareholders benefit, for example, from: obtaining a market valuation for their shares; an increased share price because of increased liquidity; the chance to use those higher-priced shares as a means of payment in takeover finance and otherwise; access to minority shareholders as a source of funding; easier exit; and a chance to diversify their holdings better.

However, a stock exchange listing would also increase disclosure duties and the duties of the board to protect the interests of the company and its minority shareholders. If those duties are effective (in many countries they are not), they can act as a constraint on how controlling shareholders can exercise control.

Managers would benefit from the duties of the board to protect the interests of the company and its minority shareholders and generally from the adoption of acceptable corporate governance practices. In principle, legal rules and market practices could help to shield the management from large shareholders. In addition, a company with dispersed ownership is typically controlled by its managers; this tends to be combined with higher pay and the existence of stock option programmes.[132]

On the other hand, the board and managers of a listed company must comply with a large body of legal rules and corporate governance practices designed to make them more effective. Increased disclosure and the market for control may act as a constraint.

Going public can bring many benefits to the firm: (a) A stock exchange listing gives the company's shares a market and a market valuation. (b) A market valuation of shares and easier exit for their holders can make it easier for the company to ask for a better price for the shares that it issues. (c) A market will generally help the company to broaden its shareholder base. In addition, some institutional investors, such as pension funds, have internal rules that prevent them from investing in securities that are not liquid. A stock exchange listing will increase both the number of institutional investors that might be interested in buying the shares and the share price. (d) A market valuation makes it easier for the company to use its shares as a means of payment. For example, shares can be used as a means of payment in takeovers, and tradeable shares make it easier for the company to introduce share option programmes. (e) A stock exchange listing makes it easier for the founders and existing owners of the company to exit the company. (f) In other words, a listing can give the firm easier access to capital for growth. (g) A stock exchange listing can also make the company better known,

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[130] Article 5 of Directive 2001/34/EC (Listing Directive).
[131] Article 11(1) of Directive 2001/34/EC (Listing Directive).
[132] Bebchuk LA, Fried JM, Walker DI, Managerial Power and Rent Extraction in the Design of Executive Compensation, U Chic L R 69 (2002) pp 751–846.

give it a higher public profile, increase sales, reduce the perceived risk of its contract parties, and enable it to negotiate better contract terms. (h) A contributing factor is that companies whose shares have been admitted to trading on a regulated market must put in place a better risk management system, disclose more information and ensure greater operating efficiency.

However, going public can also cause the firm many problems. The problems relate to susceptibility to market conditions, costs, disclosure requirements and loss of privacy, as well as potential loss of control. For many reasons, a stock exchange listing is expensive: (a) The market valuation of shares may not always reflect the quality of the firm. For example, smaller firms can suffer from the illiquidity of their shares, and adverse market conditions will influence share price. (b) Going public will cause large one-off costs. (c) In addition, compliance with the requirements of a stock exchange listing requires plenty of management time. (d) Listed companies must comply with a large and detailed regulatory framework (based on company law, capital markets law, stock exchange rules, IFRS and other accounting rules). There is an increasing amount of regulation both in the EU and the US. (e) For this reason, a listed company must enforce a compliance programme, which can be expensive. In the US, the Sarbanes-Oxley Act is a good example of legislation that increases listed companies' compliance costs. (f) Listed companies must comply with a strict information management and disclosure regime. (g) Because of disclosure obligations, listed companies are more transparent than unlisted companies. Not only investors but even competitors can benefit from the firm's loss of privacy. (h) Listed companies are on the market for control, unless they employ structural takeover defences (section 18.3). Anyone can buy a share block that confers important rights in the company, and anyone can make a bid for the whole company. (i) Short-term shareholders (for example hedge funds, investment funds, private-equity firms) may try to force the firm to further their own short-term interests rather than the long-term interests of the firm. For example, short-term shareholders can accept exorbitant remuneration packages and share option programmes in order to make managers act in the short-term interests of shareholders. The long-term survival prospects of the firm's business organisation are reduced, if shareholders and managers agree to align their interests for their own short-term benefit. (j) Listed companies must also comply with strict rules on the equivalent treatment of shareholders.

In practice, the choice between being a privately-owned company or a listed company was, to some extent, influenced by five things in the early 2000's: (1) private equity and the takeover market; (2) the profitability of firms; (3) access to debt and the level of interest rates; (4) the valuation of shares; and (5) the cost of a stock exchange listing.

This is for the following reasons. (1) Whereas private-equity firms will obtain private benefits of control after the takeover, small investors will not have any access to private benefits of control. This one of the reasons why private-equity firms have been prepared to pay more for shares than small investors have been prepared to pay. Furthermore, even an industrial investor (with access to private benefits of control) is typically prepared to pay more for shares than small investors are prepared to pay. For this reason, it often used to be more attractive to

sell the business to a private-equity firm or an industrial enterprise than to go public. (2) The high profitability of firms and access to cheap debt in the early 2000's meant that it was unnecessary for many unlisted firms to offer their shares to the public. Listed firms tended to return funds to shareholders in the form of share buybacks and dividends. (3) Where the cost of debt is low, firms may prefer debt. In addition, a high gearing increases return on equity and can act as a takeover defence. Access to low-cost debt was relatively easy in the early 2000's (but access to any kind of financing from the capital market was practically impossible during the financial crisis that began in 2007 because of the drying-up of the interbank market and the meltdown of financial assets). (4) The high valuation of shares before the crisis could, in principle, have increased IPOs as a form of exit by giving the owners of unlisted firms (for example, private equity funds) an opportunity to obtain a high price for their shares. However, as said above, private-equity firms and industrial buyers were often able to pay more. (5) Finally, the high cost of complying with the Sarbanes-Oxley Act and the risk of class actions put off many foreign companies from listing in the US. At the same time, the increased sophistication of their home stock markets encouraged companies to seek IPOs in their home market.[133]

Foreign firms may prefer the London Stock Exchange or their own national stock exchanges.[134] For example, the IPO of Qimonda AG in August 2006 was the first IPO of a German firm on the NYSE since 2002.[135] The Hong Kong Stock Exchange has also been a big beneficiary.[136] On the other hand, there is new legislation caused by the Sarbanes-Oxley Act. This legislation increases the cost of a stock exchange listing and may keep some companies private in the future.

Therefore, the firm (or its controlling shareholders) may choose to go public for many reasons such as the following: (a) the firm is very large; (b) the firm needs more equity and the controlling shareholder wants to retain control by opting for a large number of small shareholders (after an IPO) instead of one or more powerful financial or industrial investors (private placement); (c) the firm plans to grow through takeovers; (d) the founders or existing shareholders want to exit the company without selling the company's shares to a private-equity firm or a competitor; (e) market investors are prepared to pay an exceptionally high price for shares (such as during the dot-com bubble); (f) founders and existing

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[133] See The Department of the Treasury, The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure (March 2008) p 2: "Due to its sheer dominance in the global capital markets, the U.S. financial services industry for decades has been able to manage the inefficiencies in its regulatory structure and still maintain its leadership position. Now, however, maturing foreign financial markets and their ability to provide alternate sources of capital and financial innovation in a more efficient and modern regulatory system are pressuring the U.S. financial services industry and its regulatory structure."

[134] See, for example, Metso Corporation, stock exchange release of 26 July 2007.

[135] Ausländische Unternehmen meiden Amerikas Börsen. Qimonda wird erster Börsengang eines deutschen Unternehmens an der NYSE seit 2002, FAZ, 9 August 2006 p 18.

[136] London as a financial centre. Capital City, The Economist, October 2006.

shareholders can benefit from temporary market bubbles by selling shares when the price is high (for example, the IPO of a listed company's subsidiary at the peak of the market cycle); or (g) there are marketing reasons (a listed company is better-known) or other business reasons (for example, the change of corporate culture in a previously state-owned enterprise, increased external pressure, etc) for going public.

This can be illustrated by the listings of private-equity funds. According to The Economist, several factors were driving the flurry of listings in 2007: "Firms are keen to raise 'permanent capital', providing them with a big pool of funds upfront that they can invest without fear of redemptions; and company founders want to put money in the bank while fund valuations look healthy. For investors such as pension funds, buying a stake in a listed entity may appeal if their internal rules stop them investing directly in private-equity or hedge funds. Listed funds can also help investors avoid the risks of long lock-up periods."[137]

5.6 Legal Aspects of Equity Provided by Shareholders

5.6.1 General Remarks

There are various kinds of shareholders (shareholders, members, partners) depending on the enterprise form of the firm, and the legal aspects of equity capital provided by shareholders depend, to a large extent, on the enterprise form. However, some legal questions are general (generic) and characteristic of such equity regardless of the firm's enterprise form. As regards public limited-liability companies, many of those questions have been approximated by legal instruments adopted by Community institutions.

In the following, a general discussion of legal aspects characteristic of shares in a legal entity will be followed by the specific legal aspects of shareholders' equity in four forms of legal entities: the partnership, the limited partnership, the private limited-liability company, and the listed public limited-liability company. The legal aspects of other forms of equity will be discussed in the context of mezzanine financing (Chapter 6).

5.6.2 General Legal Aspects of Shares in Legal Entities

The general (generic) legal aspects that are characteristic of shares in all legal entities relate to the following questions: (a) the rights attaching to shares; (b) repayment of investment in shares and withdrawal of shares; (c) the extent of management discretion; (d) the transferability of shares; and (e) duties of disclosure.

[137] Lifting the lid, The Economist, January 2007.

The rights of shareholders attaching to shares. To begin with, the juridical nature of the relationship between a legal entity and its shareholders depends on the law governing the entity. In partnerships, it is typically regarded as one of contract. In a limited-liability company, the rights of shareholders are, in any case, governed by provisions of company law and the articles of association of the company. Whether that relationship is regarded as a contractual one can depend on differing ideas about whether that legal framework should be complemented by legal background rules applicable to contracts in general.

In a *German* limited-liability company, the rights of shareholders are based on company law statutes and complemented by general principles under the BGB. As that legal framework is complete and there is little room for the application of principles of contract law, it would be neither necessary nor meaningful to regard the relationship between shareholders and the company, or between shareholders inter se, as a contractual one. According to *English* law, a contractual relationship subsists between a company and its members and also between its members inter se.[138] However, that contract is only a "statutory contract" and parties to that fictive contract do not necessarily have recourse to all company law remedies.[139]

Regardless of the legal nature of that relationship, shareholders can have three kinds of rights attaching to their shares: economic rights;[140] governance rights;[141] and information rights.[142] Those rights can overlap.

Economic rights range from (a) a right to profits that the entity distributes to its owners to (b) a right to a share of what is left after all debts have been paid in the liquidation of the entity.

Governance rights include a limited or an unlimited power to decide on fundamental matters (such as the existence of the entity as a legal person, the contents of articles of association or similar constitutional documents, and structural change), capital and ownership structure (such as the issuance of new shares), management matters (such as the appointment of managers and decisions on management matters in general), and the exercise of remedies available to owners of shares.

Information rights vested in owners of shares are complemented by the duties of company representatives to disclose information to the public (such as the duty to disclose financial information, see section 5.9.4 and Volume I), shareholders in general, or a particular shareholder. The purpose of information rights vested in shareholders is to help them, first, to take decisions on the basis of useful information (for the usefulness of information, see Volume I) and, second, to monitor the performance of their investments and the management of the firm.

Management of economic rights. Shareholders' rights affect the firm in many ways, and it is in the interests of the firm to manage the allocation of those rights.

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[138] Section 33 of the Companies Act 2006.
[139] See Rayfield v Hands [1960] Ch 1.
[140] In German: Vermögensrechte.
[141] In German: Mitwirkungsrechte.
[142] In German: Auskunfts- und Einsichtsrechte.

By managing shareholders' economic rights, the firm can manage the distribution of value created by the firm as well as the remuneration of its stakeholders. In addition, the firm can ensure that its assets will not be expropriated by shareholders.

The interests of the firm are not necessarily the same as the interests of its shareholders (Volume I). The firm should therefore ensure that those economic rights are constrained and that they will not endanger the long-term survival of the firm.

In a *limited-liability company*, the distribution of assets to shareholders is usually constrained by mandatory provisions of law or articles of association which provide: that decisions on the distribution of assets to shareholders must be initiated by or require the consent of the statutory board (allocation of power); that the distribution of profits to shareholders may not exceed a certain amount (restrictions on distributable profits); or that the distribution of assets is prohibited if the company is insolvent or if the distribution would lead to its insolvency (equity-insolvency test). In a *partnership*, the distribution of assets to partners is constrained by: the fact that distributions are based on a contract between the partners and that any amendment of that contract usually requires consensus (partners' veto rights); and the partners' unlimited liability for the obligations of the partnership (alignment of interests).

As different shareholders have different preferences, the firm can manage their remuneration and the cost of equity by creating different classes of shares.

In a *limited-liability company*, so-called preference shares typically give the owner the right to collect a fixed dividend from the firm when funds are available for distribution, with higher priority than regular shareholders. Better economic rights may be a compensation for weaker governance rights. Preference shares often give the owners less voting power (often no voting rights). In a *partnership*, the parties may agree on the allocation of profits according to the partners' preferences.

Management of governance rights. By managing the governance rights of shareholders, the firm can manage the allocation of power in the firm. Through the allocation of power, it can also manage the perceived risk exposure of shareholders and the risk inherent in agency with the firm as principal and shareholders as agents.

The perceived risk exposure of shareholders will affect the price that the firm must pay for the use of capital provided by shareholders. If shareholders are given a say in the management of the firm, their perceived risk might be reduced. This might reduce the cost of equity capital for the firm.

For example, shareholders in listed German companies have traditionally enjoyed stronger formal powers than shareholders in listed US companies.[143] (The valuation of listed US

[143] See Cheffins BR, Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century, AJCL 51 (2003) pp 473–503; Bebchuk LA, The Case for Increasing Shareholder Power, Harv L R 118 (2005) pp 833–914; Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005) Chapter 6.

companies has nevertheless usually been higher than the valuation of listed German companies.) In continental Europe, shareholders typically decide on the change of rights attaching to shares, transactions that affect the number of shares or the share capital of the company, distribution of assets to shareholders, and structural changes. The same principles have been adopted in the Second Company Law Directive.[144]

On the other hand, the allocation of power in the firm is also a question of how the firm manages its agency relationships. As mentioned in Volume I, both shareholders and managers can be regarded as the firm's agents. The firm can improve its survival chances by managing these agency relationships for example in the following ways.

First, the firm can mitigate the risk of short-termism by limiting the powers of short-term financial investors.

For example, small shareholders have traditionally been given weak formal powers in listed US and UK companies. The firm can also try to mitigate the risk of expropriation of assets by controlling shareholders by limiting their formal powers.

Second, the firm can ensure that the power to decide on ownership structure, the issuing of new shares, share buybacks, and the redemption of shares is vested in a corporate body that furthers the long-term interests of the firm (the board, see Volume I).

In listed US companies, this is achieved through articles of association (by-laws) that vest practically all powers in the board. In the EU, however, the Second Company Law Directive vests important decision rights in the general meeting. In entities that resemble partnerships, shareholders will not permit such decisions to be delegated to managers. For example, the identity of other shareholders is crucial, if all shareholders are personally liable for the debts of the entity or where ownership of the firm means a business relationship with the firm's other shareholders.

Third, the firm can also mitigate the risk of bad management decisions. This can be done by separating decision management and decision control (Volume I). For example, shareholders can be given veto rights over major transactions and structural change as well as appointment rights; at the same, their initiation rights can be restricted.

Fourth, the firm can use financial incentives to mitigate the agency problem caused by the fact that controlling shareholders have large formal and de facto governance powers which they can use for the benefit of the firm or for their own benefit. For example, in addition to governance powers, controlling shareholders can be given unlimited liability for the obligations of the entity, liability for loss in the event of insolvency, or liability for any loss or damage sustained by the entity through their actions. This is usually achieved through the choice of the business form of the legal entity, through provisions in the entity's rules or articles, or contractually.

[144] Directive 77/91/EEC (Second Company Law Directive). See Articles 11, 17, 19, 25, 29, 30, 31, 35, 36, 37, 38, and 41.

In a partnership, partners have unlimited liability. In company law, some jurisdictions apply the doctrine of lifting the veil or Durchgriff or particular legal rules to make the controlling (or sole) shareholder liable (section 10.6), and incorporation in a certain jurisdiction means that the mandatory provisions of its company and insolvency laws will apply. The firm can also ensure that its obligations are secured by guarantees or collateral given by controlling shareholders.

A further way to reduce the risk of bad management decisions is transparency and the disclosure of information.

Management of information rights. Part of the management of outgoing information (Volume I) consists of the management of shareholders' information rights and the entity's or its representatives' duties to disclose information to the public, to shareholders in general, or to particular shareholders.

Disclosure can be in the interests of the firm. Disclosure of information to shareholders may help the firm to reduce shareholders' perceived risk and the cost of equity. Disclosure can also be used as a monitoring tool for the purpose of mitigating agency risks, in particular the risk of bad management decisions.

However, disclosure is not always in the best interests of the firm. The firm can manage the duty to disclose financial information to the public through the choice of its business form (for example, partnership v limited-liability company) and share ownership structure (for example, a privately-owned limited-liability company v a listed company; or a listed company with public disclosure obligations as a major owner of shares). This is one of the reasons why large German discounters such as Aldi and Lidl tend to be privately-owned and secretive.

Such choices will also influence duties to disclose information to shareholders in private. A shareholder typically has unlimited information rights where the shareholder is personally liable for the obligations of the entity (for example, in partnerships). In limited-liability companies, however, there is a higher risk that shareholders will abuse information disclosed to them or reveal it to third parties to the detriment of the firm. This risk can be mitigated by limiting their information rights in general,[145] by limiting rights to selective (private) disclosure, and by ensuring that effective non-disclosure obligations and sanctions for breach of confidentiality obligations are in place before making any selective disclosure.[146]

Duties of disclosure. The firm may have to disclose information to shareholders in various ways. There are few mandatory rules on the disclosure of information in partnerships. However, there are plenty of mandatory rules for limited-liability companies.

For example, a limited-liability company is required to disclose information when it decides on a new share issue or the reduction of outstanding shares. Information may have to be disclosed to the body, often the general meeting, that decides on the transaction (for issues that must be decided on by the general

[145] For example, see § 131 AktG; § 51a GmbHG.

[146] See, for example, Articles 6(2) and 6(3) of Directive 2003/6/EC (Directive on market abuse).

meeting, see above), as well as to potential investors or the public. Financial information may have to be disclosed to existing shareholders or the public on a regular basis (section 5.9.4 and Volume I). A company whose shares have been admitted to trading on a regulated market must comply with extensive disclosure obligations (section 5.9).

The management of duties of disclosure is a form of management of outgoing information. The firm can reduce its disclosure duties in many ways. (a) The firm may choose the business form of a partnership or at least avoid incorporation as a public limited-liability company. (b) If the firm is incorporated as a limited-liability company, the firm can avoid offering shares to the public. The offer of shares to a small previously defined group of professional investors (private placements) will trigger less extensive disclosure duties and less extensive duties to publish a prospectus (for the duty to publish a prospectus, see section 5.9.3). (c) The firm can also use a pyramid structure (Chapter 7) or special purpose vehicles (Volume II) when offering shares to a small group of investors.

The extent of managers' discretion. The way to generate value, the allocation of value generated by the firm, and the allocation of risk belong to the firm's most important strategic choices. These choices should preferably be made by corporate bodies responsible for furthering the long-term interests of the firm (Volume I). For this reason, the board should have discretion as to how equity is raised, increased, and reduced.

However, the raising and reduction of equity can adversely affect the interests of existing shareholders. The raising of new equity by issuing new shares can dilute their existing powers and their share of profits. The reduction of equity by means of buybacks, redemption, withdrawal or otherwise can, in the worst case, mean that a shareholder is ousted from the firm or loses the value of his investment.

Depending on the choice of the business form of the firm, shareholders can be protected against such risks in various ways. (a) In a partnership, the identity of other partners is important because of partners' unlimited liability for the obligations of the partnership. The partners may agree that any change requires a contract between all partners. (b) Similar principles are often used in private limited-liability companies if they resemble partnerships. The shareholders tend to regulate important questions of management either in a shareholders' agreement or the articles of association, or both. (c) As regards the protection of shareholders in listed or public limited-liability companies, there are fundamental differences between the continental European (EU) model and the US model.

Shareholders have traditionally been protected by mandatory provisions of company law in *continental Europe*. According to continental European company laws and the Second Company Law Directive, existing shareholders have pre-emptive rights.[147] In addition, many questions relating to shares and legal capital must be decided on by shareholders. The Second Company Law Directive provides that the general meeting decides on: any increase in capital;[148] the authorisation of a company body to decide on an increase in the subscribed

[147] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).
[148] Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).

capital;[149] the withdrawal of shareholders right of pre-emption;[150] the authorisation of a company body to decide on withdrawal of shareholders right of pre-emption;[151] the authorisation to acquire own shares;[152] reduction in the subscribed capital;[153] the reduction of subscribed capital by compulsory withdrawal of shares;[154] and reduction in the subscribed capital by the withdrawal of shares acquired by the company itself.[155]

The continental European model can be contrasted with the *US model*. In a large listed US company, the board usually has plenty of discretion to decide on the raising of equity and its reduction. Investors are expected to reward or punish the company through the market. They reward the company by buying or holding on to their shares (which will increase the share price and reduce the cost of equity), or punish the company by selling their shares (which will reduce the share price and increase the cost of equity).

It is characteristic of company laws both in the US and Europe that the exercise of the board's powers is constrained by open rules such as the duty to act for a proper purpose and the principle of equivalent treatment of shareholders.

(d) In a large co-operative, members are protected in a slightly different way. Each membership is standardised. Each member has an equal share, each share is small, and members are expected to benefit primarily when they use the services of the co-operative. They will exit the co-operative by requesting redemption for cash. As each membership is standardised, management can be given some discretion to decide on the acceptance of new members and the termination of membership.

Depending on the choice of the business form, managers may be given discretion to decide on shares in different ways. (a) In a small partnership, partners must, in practice, be responsible for management because of their personal unlimited liability. There is no separate manager class that could have discretion to decide on partners' shares. A management class may, in practice, become necessary in a large partnership such as a large law firm. Powers to decide on shares can be vested in a management body by the partners. (b) In a limited-liability company, the discretion of the statutory board depends on many choices relating to shares and the distribution of power in the company (section 5.6.5).

The transferability of shares. The transferability of shares is an important corporate governance tool which also influences the cost and availability of equity.

In a partnership, the partners may agree on the terms of exit and how a membership may be transferred. Because of the contractual nature of partnerships and the unlimited liability of partners, shares in a partnership cannot, in practice, be made freely transferable.

This can be contrasted with limited-liability companies. The transferability of shares belongs to the core characteristics of a limited-liability company, and the sale of shares is an important form of exit. But although shares issued by a

[149] Article 25(2) of Directive 77/91/EEC (Second Company Law Directive).
[150] Article 29(4) of Directive 77/91/EEC (Second Company Law Directive).
[151] Article 29(5) of Directive 77/91/EEC (Second Company Law Directive).
[152] Article 19(1) of Directive 77/91/EEC (Second Company Law Directive).
[153] Article 30 of Directive 77/91/EEC (Second Company Law Directive).
[154] Article 36 of Directive 77/91/EEC (Second Company Law Directive).
[155] Article 37 of Directive 77/91/EEC (Second Company Law Directive).

limited-liability company can be freely transferable, there can be shares the transferabilify of which is subject to restrictions (Volume I). (a) Generally, the management of the transferability of shares can influence the terms on which a limited-liability company can raise equity. The firm can benefit from the free transferability of its shares. Free transferability can increase the number of shareholders and mean that there is a market for shares. Free transferability and better liquidity can reduce investors' perceived risk, increase share price, and reduce the firm's costs for equity. Securities cannot be admitted to trading on a regulated market unless they are freely transferable. (b) On the other hand, if shares are freely transferable, anyone can buy them. The firm may restrict the transferability of shares as a takeover defence (section 18.3 and Volume I). The transferability of shares is often subject to restrictions in those limited-liability companies that resemble partnerships. For example, the statutes of some companies may provide that shares cannot be transferred without the consent of the board. (c) Furthermore, large-scale sales of shares can depress share price. The fear of large-scale sales can have the same effect. For this reason, the firm might limit the sale of shares. For example, lock-up clauses are usual in IPOs (section 5.10.2).

According to a lock-up clause, important investors (such as banks, institutional investors and large shareholders) have agreed not to sell their shares during a lock-up period. The lock-up clause is a way to signal to smaller investors that there will not be any massive sales of shares just after those investors have subscribed for their shares. As this will reduce perceived risk, smaller investors are assumed to accept a higher price when subscribing for the shares.

Withdrawal of funds. Whether and how a shareholder can withdraw funds from the firm depends largely on its business form (Chapters 9 and 10). In a partnership and limited partnership, the withdrawal of funds is a contractual matter. In a limited-liability company, however, it is constrained by legal rules that restrict distributions to shareholders.

In both cases, it may be in the interests of the firm to limit the withdrawal of funds. An unlimited right to withdraw funds from the firm would increase refinancing risk and the risk of insolvency.

For example, a hedge fund or a private equity fund could ask investors to agree to a lock-up according to which they must keep their money in the fund for a minimum period before redeeming it. In a hard lock-up, investors have no right to redeem before their time is up; in a soft lock-up, they can get out early but have to pay a redemption fee of, for example, 3%-5%. Most funds manage to bargain for one to two years. A five-year lock-up would be unusual in the fund industry.[156] Lock-up clauses will be discussed in the context of exit.

[156] All locked-up, The Economist, August 2007.

5.6.3 Shares in Partnerships

A partnership is a type of business entity in which partners share with each other the profits or losses of the business undertaking in which all have invested. In Roman law, the partnership was known as the societas. Nowadays, a partnership is usually a contract between individuals who agree to: carry on a business enterprise; contribute to it by combining property, knowledge or activities; and share its profits. Most partnerships are family businesses, but they can also be used in joint ventures and projects with a limited duration.

The most basic form of partnership is the general or unlimited partnership. It is characteristic of the most basic form of partnership that all partners have unlimited liability for its obligations. All partners usually manage its business.

Depending on the governing law, a partnership either is or is not regarded as a separate legal entity. Whether it is regarded as one can depend on whether it is registered.

Under *German* law, an unregistered partnership (a company constituted under civil law, Gesellschaft des bürgerlichen Rechts, GbR) will not be regarded as a legal person. It cannot sue or be sued. It is often used for construction projects and other similar joint venture projects. If a GbR is registered with the commercial register, it turns into an unlimited partnership (Offene Handelsgesellschaft, OHG) (or a limited partnership, Kommanditgesellschaft, KG, see below). An unlimited partnership (OHG) itself is not regarded as a legal entity in Germany. However, it may acquire rights and incur liabilities, acquire title to real estate, and sue or be sued.[157]

Some investors favour partnerships over corporations for taxation purposes, as a partnership structure can eliminate the dividend tax levied upon profits realised by the owners of a corporation.

The rights of partners. Partners' rights will be regulated in the partnership agreement. Because of unlimited liability, the most basic partners' rights are the right to participate in the firm's management and the right to access the firm's books.

The extent of management discretion to raise equity by issuing shares and to reduce equity. Because of their unlimited liability, it is for partners to agree on the ownership structure of the partnership. For example, a partner cannot be expelled by majority decision.[158]

The transferability of shares. For the same reason, shares in a partnership are not freely transferable. A partnership agreement is an agreement with two or more parties, and the transferability of a share would mean the assignment of the rights and obligations of a party.[159]

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[157] For English law, see the Partnership Act 1890.

[158] Section 25 of the Partnership Act 1890: "No majority of the partners can expel any partner unless a power to do so has been conferred by express agreement between the partners."

[159] See nevertheless section 31(1) of the Partnership Act 1890.

Duties of disclosure. Because of unlimited liability, a partner typically has full access to the books and documents of the firm. Other partners have a duty of disclosure.[160] In addition, the parties' mutual disclosure duties are typically based on the principles that govern the general disclosure duties of contract parties (Volume II).

5.6.4 Shares in Limited Partnerships

Two other forms of partnerships are the limited partnership (LP, KG, société en commandite, società in accomandita) and the limited liability partnership (LLP). Limited partnerships were known in Roman law (societates publicanorum) as well as in medieval Italy (commenda). Limited partnerships belong to the most popular enterprise forms in continental Europe. They did not become as popular in England because English business practice used to lag behind that of continental European countries in book-keeping.[161]

The limited partnerships can be used by many kinds of firms. (a) Limited partnerships are often used by investment funds because of company law reasons (it can pass through profits from investments to fund investors, see also section 10.5) and because of tax reasons (often it is tax transparent or pass-through for tax purposes). Private-equity firms almost exclusively use a combination of general and limited partners for their investment funds. Typically, the general partner that manages the limited partnership will provide 1%-3% and a large number of limited partners the rest of the limited partnerships equity capital. The latter will often not pay right away. Instead, the limited partners promise to pay when asked to do so after a suitable acquisition target has been found (Committed Capital).[162] (b) Limited partnerships can also be useful in "labour-capital" partnerships, where one or more financial backers prefer to contribute money or resources while the other partner performs the actual work. In such situations, the general partner can use its own unlimited liability to signal the quality of the investment, and the financial investor can use it as an incentive that mitigates agency problems. (c) Most limited partnerships are nevertheless family businesses.

It is characteristic of a limited partnership that it has one or more partners with unlimited liability and one or more partners (investors) with limited liability.[163] In a limited liability partnership (LLP),[164] all partners have some degree of limited liability. The personally liable partner in a limited partnership can also be a company with limited liability. A limited liability limited partnership is common in many US states (LLLP) and in Germany (the GmbH & Co. KG). The GmbH &

[160] Section 28 of the Partnership Act 1890: "Partners are bound to render true accounts and full information of all things affecting the partnership to any partner or his legal representatives."

[161] For US law, see Kessler AD, Limited Liability in Context: Lessons from the French Origins of the American Limited Partnership, J Legal Studies 32 (2003) pp 511–548.

[162] Rudolph B, Funktionen und Regulierung der Finanzinvestoren, ZGR 2008 pp 161–184.

[163] For German law, see §§ 161–177a HGB. For Swiss law, see Art. 594(1) OR.

[164] For English law, see the Limited Liability Partnerships Act 2000.

Co. KG is a limited partnership with, typically, a limited-liability company ("GmbH") as the sole general partner and limited partners ("& Co.") whose liability is restricted to their fixed contributions to the limited partnership ("KG").

Depending on the governing law, the limited partnership (LP) either is or is not regarded as a separate legal person. Under English law, a limited partnership governed by the Limited Partnerships Act 1907 is not a legally separate entity,[165] but an LLP governed by the Limited Liability Partnerships Act 2000 is a legal entity independent of its members.

The rights of partners. Partners with unlimited liability (general or unlimited partners) typically have the same rights and obligations as partners in a general or unlimited partnership (such as the OHG). However, partners with limited liability (limited partners) also have limited rights. The partners may regulate their rights in the partnership agreement. For example, they may agree on the distribution of profit and loss.[166]

The extent of management discretion to raise equity by issuing shares and to reduce equity. A limited partnership is managed by general partners. A limited partner usually cannot take part in its management.[167] The partnership agreement can lay down to what extent the firm may raise new equity.[168] Although the limited partnership is a flexible business form, there may be legal constraints on the repayment of the capital investment of limited partners.[169]

The transferability of shares. Shares in a limited partnership are not freely transferable. A limited partner may not assign his share without the consent of general partners, unless the partners have agreed otherwise.[170]

Duties of disclosure. As in a partnership, partners have access to books[171] and have mutual disclosure duties.

5.6.5 Shares in Private Limited-liability Companies

In a limited-liability company, the limited liability of all shareholders can increase the potential conflict of interest between the firm and its shareholders. The firm should manage both the firm v controlling shareholder relationship as well as the firm v non-controlling shareholder relationships.

The firm may try to better align the interests of the controlling shareholder with those of the firm. For example, the controlling shareholder may undertake a contractual liability for the obligations of the firm, give a security, or provide other

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[165] See The Law Commission, Partnership Law (Report) [2003] EWLC 283(9) (15 November 2003).
[166] For German law, see §§ 121 and 168 HGB.
[167] For English law, see section 6(1) of the Limited Partnerships Act 1907.
[168] See section 6(5) of the Limited Partnerships Act 1907: "Subject to any agreement expressed or implied between the partners … (d) A person be may introduced as a partner without the consent of the existing limited partners …"
[169] See section 4(3) of the Limited Partnerships Act 1907.
[170] See section 6(5) of the Limited Partnerships Act 1907.
[171] See section 6(1) of the Limited Partnership Act 1907.

credit enhancements for the debts of the firm. Usually, the owner of a small business tends to be personally liable for some or all debts of the firm regardless of its legal form because lenders typically require personal undertakings by the owner.

In practice, the focus will be on the firm v non-controlling shareholder relationships, because the firm v controlling shareholder relationships will be managed by the controlling shareholder rather than the firm: this is what being a controlling shareholder means.

The rights of shareholders. Both controlling shareholders and minority shareholders have rights that act as a constraint on management (for controlling and minority shareholders' corporate governance tools, see Volume I).

The principle of *equivalent treatment* of holders of securities of the same class protects in particular minority shareholders. This principle belongs to the general principles of Member States' company and securities markets laws (see Volume I).

Shareholders may have *pre-emptive rights*. Shareholders' pre-emptive rights mean the right to subscribe for new shares issued by the company in proportion to existing shareholdings. In addition, pre-emptive rights may include the right to buy existing shares sold by the company. Shareholders' pre-emptive rights belong to the most fundamental principles of continental European company laws. In contrast, this was not the case in England before the Second Company Law Directive was implemented by the Companies Act 1980.

The Second Company Law Directive does not require pre-emptive rights for all shareholders.[172] First, the Directive applies only to public limited-liability companies. For example, the new Finnish Company Act of 2006 made pre-emptive rights optional for private limited-liability companies. Second, the Directive provides for pre-emptive rights "whenever the capital is increased by consideration in cash".[173] The laws of a Member State will therefore not need to apply those rights: when capital is not increased at all (this would require, as in Finnish company law, the separation of shares and capital); when capital is increased by consideration other than cash (such as shares in another company); or to the decision to issue share option rights, convertible loans, or warrants (capital will necessarily have to be increased only when those rights are exercised). Third, the laws of a Member State need not apply pre-emptive rights to shares which carry a limited right to participate in distributions and/or in the company's assets in the event of liquidation.[174]

Shareholders have *information rights* (Volume I). (a) In the EU, a private limited-liability company must disclose basic information to the public according to the First Company Law Directive.[175] (b) It must disclose periodic information according to the standards set out by the Fourth and Seventh Company Law Direc-

[172] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).

[173] Article 29(1).

[174] Article 29(2)(b). Distribution includes in particular the payment of dividends and of interest relating to shares.

[175] Directive 68/151/EEC (First Company Law Directive). See also Directive 89/667/EEC on single-member private limited-liability companies (Twelfth Company Law Directive).

tives[176] and the Directive on statutory audits.[177] Those standards are complemented by Member States' national accounting requirements.[178] (c) Shareholders use their voting rights at general meetings and will be disclosed information before each meeting or at the meeting. For example, depending on the governing law, shareholders decide on questions relating to legal capital, structural change, and appointments to the board. (d) Whether shareholders have a right to selective disclosure of information depends on the governing law. For example, shareholders have wider rights to ask for the disclosure of information in a German limited-liability company compared with an English company (Volume I).

Shareholders can have *decision rights*, which consist of *initiation* rights or *veto* rights or both. Depending on the decision and the governing law, even minority shareholders can use their voting rights as veto rights to block decisions initiated by others such as majority shareholders or the board (Volume I).

To a large extent, shareholders' *enforcement rights* depend on the governing law. One of the factors influencing the rights of a shareholder to enforce sanctions against other shareholders or the representatives of the company in the event of breach of the legal framework that governs the company's affairs is the nature of that legal framework. Where that legal framework is based on law, as in Germany and continental Europe, shareholders may have wider legal rights to enforce it (there is simply more to enforce). Where it is not based on law, shareholders are likely to have less effective legal rights to enforce it (there is less to enforce).

For example, it has traditionally been easier for shareholders of a *German* limited-liability company to enforce sanctions against the company or its board members (the duties of board members are mainly based on statutory company law) than it has been for shareholders of an *English or US* limited-liability company (these duties are largely based on articles of association and all powers have usually been vested in the board).[179] – On the other hand, class actions are easier in the US than in Europe. It is also worth noting that the City Code has gained statutory force.[180]

Management of shareholders' rights. The firm can manage the scope of shareholders' rights in various ways.

Generally, the firm can manage shareholders' rights by using the discretion available to the firm under the applicable company law. The firm may regulate those rights in its *statutes* (articles of association). However, the amendment of statutes requires the consent of shareholders and may be contrary to the interests of a shareholder block. It is therefore easier to use that discretion before the

[176] Directive 78/660/EEC on the annual accounts of certain types of companies (Fourth Company Law Directive). Directive 83/349/EEC on consolidated accounts (Seventh Company Law Directive).

[177] Directive 2006/43/EC (Directive on statutory audits).

[178] For example, § 242 HGB and § 264(1) HGB ("HGB-Abschluss").

[179] For party autonomy in corporate rule-making, see Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005) Chapters 4.1.4 (English company law) and 5.1.4 (German company law).

[180] Sections 942 and 943 of the Companies Act 2006.

company is founded.[181] Because of constraints on the use of the discretion at a later point of time, one can say that the discretion is partly "consumed" when it is used for the first time, but not "exhausted".[182]

For example, the *English* limited-liability company is regarded as a particularly flexible company form, but that flexibility will to some extent be consumed at incorporation, because it is easy for the company to choose the articles of association that it wants when the company is incorporated but not as easy to change them afterwards.

The firm cannot opt out of the principle of equivalent treatment of holders of securities of the same class, but the firm can have different classes of shares (Volume I). For example, a company can issue shares with different voting rights in order to ensure that new investors will not be able to block decisions on structural change or the issue of new shares.

Pre-emptive rights of shareholders are, to some extent, mandatory under continental European company laws, but the laws of a Member State may provide that the pre-emptive rights of shareholders are not mandatory in private limited-liability companies.

For example, *Finnish* company law permits a private limited-liability company to exclude pre-emptive rights in its articles of association. In addition, the general meeting may decide to waive pre-emptive rights or authorise the board to decide on share issues and the disapplication of pre-emptive rights. Such an authorisation will increase flexibility.

Shareholders' statutory information rights are usually minimum rights that cannot be waived by the company. They are mandatory for two reasons. First, rules on public disclosure protect not only shareholders but even creditors and other third parties. Second, the purpose of shareholders' information rights is to protect not only shareholders in general but minority shareholders in particular.

There are seven main ways for a company to manage shareholders' decision rights and their exercise in a private limited-liability company with few shareholders.

First, they can partly be "consumed" and restricted by the company's statutes. Generally, the contents of the statutes act as a constraint on corporate decision-making. The statutes must lay down certain specific constraints such as the company's objects clause. In addition, they can also set out the allocation of power between the general meeting and the board. This is easier in countries like England where the internal allocation of power is mainly regulated in the company's articles of association, and less flexible in countries as Germany where the allocation of power in a limited-liability company is mostly governed by mandatory company law rules.

Second, the company may regulate the majority required for the resolutions of the general meeting. This is a double-edged sword. A simple majority will

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[181] See, for example, Mäntysaari P, *op cit*, Chapter 6.

[182] For the concept of "exhaustion of rights" in EU competition law, see Case 15/74 Centrafarm v Sterling Drug [1974] ECR 1147.

normally suffice. Where the statutes of the company require a larger majority, a smaller minority will be able to block the decision. The requirement of a large majority will, in practice, lead to management by consensus or, in the worst case, make decision-making slower or more difficult.

Third, the company can encourage shareholders to regulate the principles of the exercise of shareholders' powers in a shareholders' agreement.

Fourth, where the company is subject to the legal capital regime, the company can regulate the amount of its fixed minimum legal capital and the reserves that may not be distributed to shareholders in its statutes.

Fifth, the company can influence its share ownership structure by share issues and the choice between rights issues (which will not dilute the ownership rights of existing shareholders provided that all of them subscribe for new shares) and other issuings of shares (which will dilute the ownership rights of existing shareholders). For example, the company may finance a business acquisition by issuing new shares to the seller.

Sixth, share buybacks and the redemption or withdrawal of shares can mean that a shareholder will end up owning a larger part of the company's shares, and the shareholder may get better access to minority rights or a qualified majority if certain thresholds are exceeded. On the other hand, the exceeding of a threshold can also trigger obligations for a shareholder (such as consolidation or a duty to make a bid for the remaining shares).

The company can issue new shares to other investors in order to ensure that the threshold will not be exceeded. This will usually require a resolution by the general meeting and co-operation by the shareholder whose ownership rights will be diluted.

Seventh, depending on the governing law, a majority shareholder may have a "squeeze-out right" giving him the right to buy the remaining shares from minority shareholders. A "squeeze-out right" may be complemented by minority shareholders' "sell-out right" (section 10.3.2). Without minority shareholders, it will be legally less complicated to manage the company's capital.

This can be illustrated by the case of Boss AG and Permira, an English investment fund. In 2008, Permira owned almost 90% of shares in Boss AG. Although Permira was a very big shareholder, it had to convince minority shareholders and the two boards of Boss AG to distribute funds to shareholders. It could not force the company to do so.[183] Permira did not have full control of Boss because of the existence of minority shareholders.

Shareholders' enforcement rights are normally based on mandatory provisions of law. Minority shareholders' enforcement rights depend on the jurisdiction, but usually they have few legal powers to enforce sanctions against defaulting board members or managers.[184] The two main ways for the firm to manage shareholders'

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[183] Lembke J, Mode: Interesse an Geld, nicht an Farben und Design, FAZ, 13 May 2008 p 27.

[184] See Mäntysaari P, *op cit*, Chapter 6.

enforcement rights are (1) compliance with legal rules and (2) management of the size and voting power of minority shareholder blocks.

The extent of managers' discretion. In continental Europe, shareholders have traditionally been protected by mandatory provisions of company law that govern the authorised capital and the distribution of power in the company. The general meeting decides on the amendment of the company's statutes as well as on an increase or decrease in the number of shares (section 5.10.3). In addition, actions by the board are constrained by the general principle of equivalent treatment of holders of securities that belong to the same class and general principles according to which the board must act for a proper purpose (Volume I). Such rules and principles are likely to decrease the board's discretion to issue shares and buy them back or to redeem or withdraw them.

However, there are two main ways to increase board discretion. The first can be used ex ante and the second ex post. First, the discretion of the statutory board will depend on many *choices relating to shares*.

- Depending on the governing law, the limited-liability company may need to have an authorised capital such as a share capital. If it has an authorised capital, each share can be regarded as a share of the authorised capital (as under German company law). Alternatively, shares are not linked to authorised capital (this is the case according to Finnish company law). The latter alternative is likely to increase management discretion, because a change in the number of shares will not necessarily require a change in the authorised capital, and vice versa. The lack of an authorised capital would increase flexibility even more.[185]
- In the EU, the public limited-liability company must have an authorised minimum capital.[186] Depending on the governing law, the statutes of the company may provide that the authorised capital may be changed within the limits of a minimum and maximum capital without amending the statutes. The use of a minimum and maximum capital instead of a fixed capital is likely to increase management discretion.
- The same can be said of information about the number of shares in the company's statutes.[187] The use of a minimum and maximum number is again likely to increase flexibility.
- Depending on the governing law, the shares can have a nominal value or an accountable par value. The Second Company Law Directive provides that "shares may not be issued at a price lower than their nominal value, or, where there is no nominal value, their accountable par".[188] There will be more flexibility, if the company chooses an accountable par value for its shares instead of a nominal value.

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[185] See Enriques L, Macey JR, Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules, Cornell L R 86 (2001) pp 1165–1204; Armour J, Legal Capital: an Outdated Concept? EBOLR 7 (2006) pp 5–27.

[186] Article 6(1) of Directive 77/91/EEC (Second Company Law Directive).

[187] Articles 3(a) and 3(b) of Directive 77/91/EEC (Second Company Law Directive).

[188] Article 8(1) of Directive 77/91/EEC (Second Company Law Directive).

- Depending on the governing law, the articles of association may provide that the company has, in addition to a fixed capital, reserves that may not freely be distributed to shareholders. The company can also have reserves that are not subject to such restrictions under its articles of association. The use of the latter will make decision-making easier (but give shareholders more power to require distributions).
- When the company issues shares, it can issue them at a premium and ensure that the use and distribution of the premium will not be covered by such restrictions.
- Pre-emptive rights belong to the most fundamental rights of shareholders under continental European company laws, and the Second Directive provides for the pre-emptive rights of existing shareholders.[189] Depending on the governing law, the board may nevertheless have discretion to issue shares or rights to shares. In principle, the Second Directive does not require pre-emptive rights for all shareholders. First, the Directive applies only to public limited-liability companies.[190] Second, the Directive provides for pre-emptive rights "whenever the capital is increased by consideration in cash".[191] The laws of a Member State will therefore not need to apply those rights: when capital is not increased at all;[192] when capital is increased by consideration other than cash (such as shares in another company); or when the company decides to issue share option rights, convertible loans, or warrants (capital will necessarily have to be increased only when those rights are exercised). Third, the laws of a Member State need not apply pre-emptive rights to shares which carry a limited right to participate in distributions and/or in the company's assets in the event of liquidation.[193]
- The company may have different classes of shares depending on the governing law. For example, the statutes of the company may provide that the company may issue redeemable shares (section 10.2.5). The existence of redeemable shares will make it easier for the board to decide on the reduction of the number of shares and the reduction of capital.

Second, the discretion of the statutory board will depend on the *distribution of power* in the company. Even where decisions on shares will have to be taken by the general meeting under mandatory provisions of company law (see above), the general meeting may empower the board to take the decisions subject to certain conditions. For example, the boards of listed companies have usually been author-

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[189] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).

[190] For example, the new Finnish Company Act of 2006 made pre-emptive rights optional for private limited-liability companies

[191] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).

[192] This would require, as in Finnish company law, the separation of shares and company capital. Under Finnish company law, a "share" does not represent any right to a share of the company's "share capital".

[193] Article 29(2)(b) of Directive 77/91/EEC (Second Company Law Directive). Distribution includes in particular the payment of dividends and of interest relating to shares.

ised to issue shares or share options, purchase own shares (share buybacks), and dispose of own shares purchased by the company.

The transferability of shares. The transferability of shares belongs to the fundamental characteristics of a limited-liability company. The firm can nevertheless manage the transferability of shares in various ways (section 10.3.1, Chapter 18, and Volume I).

Duties of disclosure. The duties of disclosure have already been discussed in the context of management of information (Volume I) and will be discussed in the context of listed companies (section 5.9 and Chapter 19).

5.7 Private Placements

Section 5.6 dealt with many of the general legal aspects relating to the issuing of shares by a privately-owned limited-liability company under the EU legal capital regime. They will be discussed in more detail in sections 5.10 and 5.11. Sections 5.8 and 5.9 will discuss the large regulatory regime applicable to issuers of shares admitted to trading on a regulated market. This section (5.7) will discuss some particular legal aspects relating to private placements.

Private placements are a way to raise funds from private, institutional, or trade investors without having to comply with onerous regulations. Many start-up companies require substantial capital in order to get their business going. Private placements can generally work as a stepping-stone for companies not ready to join public markets.[194] Private placements are a very important part of raising funding in Europe.

Benefits. The use of private placements can bring many benefits to the issuer and investors. The lack of extensive regulation means that the private placement process, as a whole, is faster and cheaper. Information asymmetries can be reduced, because the parties can agree that investors participate in the valuation process. Investors can prefer to invest in the company's shares before an IPO, because the admission of shares to trading on a regulated market will increase liquidity, demand, and share price.

On the other hand, the absence of a large body of mandatory provisions of law and the private nature of private placements means that the parties will have to agree on most things. Investors are therefore exposed to a higher legal risk. Even the issuer is exposed to a higher legal risk. Akin to business acquisitions (Chapters 12–13 and 19), the management of information becomes important, because the issuer may become liable for misrepresentations or omissions on the basis of information exchanged by the parties in the course of the private placement process.

Where the shares will not be traded on a stock exchange, investors may also face problems when trying to exit the company. For example, exit may be con-

[194] Speck BD, Tanega J, Private Equity Placements: Comparing the Laws in Switzerland, the European Union, the United Kingdom and the United States of America: Part 1, JIBLR 21(4) (2006) p 213.

strained by the articles of association of the company or the terms of the investment contract.

Memorandum. Typically, the issuer prepares and disseminates disclosure documents, often referred to as private placement memoranda, to a limited number of recipients in order to find investors.

The purpose of the private placement memorandum is to manage information, as well as to reduce risk and transaction costs. The private placement memorandum contains core information about the investment. Furthermore, it contains the specific terms and conditions drafted by the issuer.[195] This means that the issuer will not have to negotiate the terms and conditions of the contract with each new potential shareholder. The investor has only to decide whether to sign the subscription form and transfer the money into the stated bank account.[196]

Private placement process. The private placement process resembles a private sale of shares initiated by the issuer or the vendor (Chapter 12; for auctions, see section 10.3.2).[197]

Regulation in general. There is nevertheless some regulation. First, there are rules regulating the activities of the participants (the issuer, intermediaries, investors). Second, there are rules on certain types of transactions (the issuance of shares, the drawing up of the prospectus, the subsequent marketing of the document, and the entering into a subscription agreement).[198] Typically, securities markets laws contain private placement exemptions.

Community law. There is no coherent set of provisions that would facilitate cross-border private placement in the EU.[199] Community law contains isolated provisions that are relevant. The two most relevant Directives are the Prospectus Directive and the MiFID.

The main effect of the Prospectus Directive is to switch off certain regulatory requirements when securities are not offered to the public. The Prospectus Directive applies to an "offer of securities to the public".[200] The definition of "public offerings" is very broad and can capture a wide range of transactions.[201] For this reason, the Directive also contains broad private placement exemptions for offers of unlisted securities.[202] If one of those exemptions is met, the obligation to publish a prospectus will not apply.

However, the Prospectus Directive can require some disclosure even when it does not require the publication of any prospectus: "When according to this Directive no prospectus is required, material information provided by an issuer or an offeror and addressed to qualified investors or special categories of investors, in-

[195] See, for example, Groner R, Private Equity – Recht. Stämpfli Verlag AG, Bern (2007) pp 105–114.
[196] Speck BD, Tanega J, *op cit*, p 215.
[197] See Speck BD, Tanega J, *op cit*, pp 215–216.
[198] Speck BD, Tanega J, *op cit*, p 215.
[199] Impact Assessment Report on private placement, Commission Staff Working Document, SEC(2008) 2340.
[200] Article 1(1) of Directive 2003/71/EC (Prospectus Directive).
[201] Article 2(1)(d) of Directive 2003/71/EC (Prospectus Directive).
[202] Article 3(2) of Directive 2003/71/EC (Prospectus Directive).

cluding information disclosed in the context of meetings relating to offers of securities, shall be disclosed to all qualified investors or special categories of investors to whom the offer is exclusively addressed."[203] This language is intended to encourage transparency by prohibiting secret information divulged to one set of investors, and not to others, and thus, discourage potential unfair advantage and potential conflicts of interest.[204]

The disclosure obligations can also depend on whether the securities are offered to investors by a financial services provider ("investment firm") as well as on how sophisticated the potential investors are.[205]

Some exemptions depend on whether potential investors are regarded as qualified investors (Prospectus Directive) or professional investors (MiFID). These concepts are different because the two regimes were created for different purposes.[206]

Investment advice is heavily regulated in the EU (Volume I). It can also be noted that the Distance Marketing of Financial Services Directive[207] establishes a set of EU-wide rules on the information that must be supplied to consumers when financial services are sold through the use of distance means (such as telephone, fax, internet, or mail). The Directive sets minimum periods of withdrawal from distance contracts.

Member States' laws. The Prospectus Directive, which tries to achieve a maximum level of harmonisation, leaves little discretion to the Member States. The exemptions under the Prospectus Directive thus determine when a private placement is private under the governing law.

On the other hand, where no prospectus is required, the disclosure obligations of the parties depend on the governing law. There are differences depending on the Member State.[208]

English law. In England, the Financial Services and Markets Act 2000 (FSMA) is the most important statute regulating securities markets.[209] The FSMA provides for a unified and media-neutral financial promotion regime. Financial promotion

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[203] Article 15(5) of Directive 2003/71/EC (Prospectus Directive).

[204] See Speck BD, Tanega J, Private Equity Placements: Comparing the Laws in Switzerland, the European Union, the United Kingdom and the United States of America: Part 1, JIBLR 21(4) (2006) p 224.

[205] Article 19 of Directive 2004/39/EC (MiFID). For Swiss law, see BGE 105 II 75, 80, E. 2.a; Groner R, Private Equity – Recht. Stämpfli Verlag AG, Bern (2007) pp 87–91.

[206] See European Securities Markets Expert Group, Differences between the Definitions of "Qualified Investor" in the Prospectus Directive and "Professional Client" and "Eligible Counterparty" in MiFID – Is Alignment Needed? November 2008.

[207] Directive 2002/65/EC concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC.

[208] Impact Assessment Report on private placement, Commission Staff Working Document, SEC(2008) 2340 pp 12–13.

[209] See Speck BD, Tanega J, Private Equity Placements: Comparing the Laws in Switzerland, the European Union, the United Kingdom and the United States of America: Part 2, JIBLR 21(5) (2006) pp 252–265.

by an unauthorised person is generally restricted.[210] For example, sending a business plan to, or discussing it with, potential investors, is a financial promotion restricted under the FSMA. This may require the sender or other persons involved in the process to be authorised in the UK or to ensure that the communication is approved by an authorised person.[211] As the scope of the restrictions is very broad, they are complemented by private placement exemptions under the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

The 144A market in the US. The costs of the Sarbanes-Oxley corporate governance regime have encouraged companies to find ways of reaching investors without trading on the public markets in the US. Non-US companies can benefit from the so-called 144A market, which allows corporate issuers to place equity or debt with a limited number of qualified investors. Companies can use the 144A rule to place securities with so-called Qualified Institutional Buyers, provided the securities are not owned by more than 500 such investors.

5.8 Shares Admitted to Trading on a Regulated Market

Shares in a public limited-liability company can be admitted to trading on a regulated market (listed), admitted to trading on an unregulated market, or privately-held (unlisted). It is characteristic of a listed company that it has a large number of small shareholders. Their interests are predominantly short term. Financial investors are protected by mandatory provisions of company law and securities markets law, meaning that issuers of securities admitted to trading on a regulated market must comply with a large regulatory regime under Community law.

After an IPO, established listed companies rarely raise finance from the capital market by offering their own shares for cash (section 5.10), because doing so would potentially depress the share price.[212] First, it would dilute the ownership rights of existing shareholders who prefer not to subscribe for new shares. Second, it would often transfer value from existing shareholders to new shareholders, because new shareholders who may buy existing shares and pay the market price will not subscribe for new shares without a discount. Third, the issuing of new shares to the public can signal bad news.

However, listed companies often offer shares to the public in other ways. For example, the company may pay for a business acquisition with its own shares (section 5.11). A takeover bid made by a listed company may consist of an exchange offer pursuant to which the target's shareholders will receive shares in the bidder for their shares in the target. Such a takeover may be a normal acquisition of shares or a formal merger.

In addition, where the firm owns shares in a listed company or a company that is in the process of going public, the firm can release capital by selling those

[210] Section 21(1) of the FSMA 2000: "A person … must not, in the course of business, communicate an invitation or inducement to engage in investment activity."

[211] Section 21(2) of the FSMA 2000.

[212] See also Myers SC, Capital Structure, J Econ Persp 15 (2001) pp 91–92.

shares (section 10.3). For example, a listed company may float shares in a subsidiary on the capital market, or a private equity fund may exit a company by means of an IPO.

Shareholders' rights. The rights attaching to shares in a listed company are usually based on the same company law principles as the rights attaching to shares in a privately-owned public limited-liability company. The rights attaching to shares in a listed company have, to some extent, been approximated by EU company and securities markets directives, the purpose of which is to protect shareholders, minority shareholders, creditors and the market in general.

As in privately-owned public limited-liability companies, shareholders have formal powers relating to legal capital and structural change. The Second Company Law Directive provides for the equal treatment of shareholders who are in the same position.[213] The Second Directive also provides that any increase in the subscribed capital must be decided upon by the general meeting[214] and that the pre-emption rights of existing shareholders may not be restricted or withdrawn without the consent of the general meeting.[215] There are similar provisions on the reduction in subscribed capital. The Second Directive is complemented by the Third Directive, which provides that a merger requires the approval of the general meeting of each of the merging companies,[216] and the Sixth Directive, which contains a similar provision on the division of companies.[217] The Takeover Directive complements the Second Directive by providing for "squeeze-out" rights of the majority shareholder and "sell-out" rights of minority shareholders in the context of takeover bids.[218]

Apart from voting at general meetings, shareholders tend to have restricted formal powers to enforce remedies against the company or its managers in the event of breach of law or the company's statutes. Some rights nevertheless exist.

For example, shareholders of a listed German AG enjoy slightly more efficient statutory remedies than shareholders of a listed English plc; even individual shareholders have a right to contest resolutions of the general meeting under German law.[219] Since those resolutions are normally based on proposals submitted by one of the two statutory boards or both of them, a shareholder may, at the same time, indirectly contest acts done by the two statutory boards.

Discretion of the board. As in a private limited-liability company (see above), the firm can manage constraints created by mandatory legal capital rules.

For example, the firm can increase the discretion of the board by ensuring that: the company's legal capital may be changed within the limits of a minimum and maximum capital without amending its statutes; the number of the company's

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[213] Article 42 of Directive 77/91/EEC (Second Company Law Directive).
[214] Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).
[215] Article 29(4) of Directive 77/91/EEC (Second Company Law Directive).
[216] Article 7 of Directive 78/855/EEC (Third Company Law Directive).
[217] Articles 5–6 of Directive 82/891/EEC (Sixth Company Law Directive).
[218] Article 15 of Directive 2004/25/EC (Takeover Directive).
[219] See §§ 245 and 249 AktG.

shares may be changed within the limits of a minimum and maximum number without amending its statutes; the shares have an accountable par value instead of a nominal value; and the company has shares which carry a limited right to participate in distributions and/or in the company's assets in the event of liquidation.

In addition, the discretion of the board may be increased by authorising the board to decide on share issues and the waiver of pre-emption rights as well as on share buybacks (for share buybacks, see section 10.2.4).

Transferability of shares. Shares admitted to trading on a regulated market must be freely transferable.[220] In addition, a sufficient number of shares (at least 25%) must be distributed to the public.[221] This can make takeover defences more important (Volume I). During public takeover bids, the use of some takeover defences is constrained by the provisions of the Takeover Directive (prohibition to frustrate the bid, requirement of shareholders' consent; see section 17.4).

Information management regime: general remarks. Listed companies must comply with a large and mandatory information management regime. There is plenty of EU legislation and accordingly plenty of implementing legislation in the Member States in this area. The purpose of this regime is to abolish differences between Member States regarding financial information disclosed by listed companies. This regime will be discussed in the following section.

5.9 Listing and the Information Management Regime

5.9.1 Introduction

When choosing where to have its shares admitted to trading, the company can choose between different markets in different countries. For example, a certain country can attract investors and issuers by the size, liquidity, efficiency and transparency of its financial markets compared with markets in other countries.[222]

In any case, the existence of a mandatory and extensive information management regime is characteristic of stock exchange listings. The basic characteristics of this regime are more or less the same for all companies whose shares have been admitted to trading on a regulated market in the EU. A regulated market means a trading system which is authorised and functions regularly in accordance with the MiFID.

Key objectives. This regulatory regime has two key objectives. (1) The first is to increase economic growth and job creation by reducing financing costs for issuers. This is done in three main ways. The regulatory regime is designed to reduce investors' perceived risk. It is also designed to reduce investors' and issuers'

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[220] Article 46 of Directive 2001/34/EC (Listing Directive).

[221] Article 49 of Directive 2001/34/EC (Listing Directive).

[222] Forbes KJ, Why Do Foreigners Invest in the United States? NBER Working Paper 13908 (April 2008).

transaction costs and the costs for maintaining a listing.[223] One of the ways to reduce costs is the promotion of competition by facilitating a level playing field between trading and settlement systems.[224] (2) The second key objective is the construction of an integrated securities market.

It is normally said that the objective of the regulatory regime for issuer access is to "promote investor confidence in the securities markets via investor-protection measures, to ensure the effectiveness and efficiency of the market-place in allocating capital, and to reduce the cost of capital for issuers seeking market finance".[225]

Information is a key factor in investor protection. Issuers in general have an incentive to provide information to reduce funding costs, because investors will discount securities in the absence of useful information. Furthermore, institutional investors might choose not to buy or hold an issuer's securities in order to protect themselves against their own liability risks.[226]

Key strategies, choice of decision-making process. The most important strategies employed at Community level contain: the approximation of laws and the recognition of national variations as equivalent; mutual recognition of regulatory requirements (see Volume I); and home country control.

In principle, the strategy of equivalence could open the door to regulatory competition. The degree of regulatory competition is nevertheless limited because of a high degree of harmonisation in this area.

The adoption and implementation of Community legislation on financial services is generally influenced by the so-called Lamfalussy approach proposed by the Committee of Wise Men.[227] The Lamfalussy approach means a four-level approach to decision-making:[228]

- Level 1 involves traditional legislative activity. Before presenting a legislative proposal in the field of securities, the Commission nevertheless consults the European Securities Committee (ESC), which comprises representatives of each Member State.

[223] See, for example, recitals 1 and 2 of Directice 2003/6/EC (Directive on market abuse) as well as recitals 10, 16 and 21 of Directive 2003/71/EC (Prospectus Directive).
[224] Moloney N, EC Securities Law. OUP, Oxford (2008) p 770: "… MiFID supports off-exchange trading by internalizers ('systematic internalizers' under MiFID). This policy is designed to promote competition between trading venues, reduce the costs of equity trading by breaking the power of the main stock exchanges, provide investors with a wider choice of trading venue, better meet the different trading requirements of retail and wholesale investors, and support innovation."
[225] *Ibid*, p 53.
[226] See *ibid*, p 93.
[227] Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (February 2001).
[228] See, for example, opinion of the European Economic and Social Committee on several proposals, 2008/C 224/07.

- Level 2 means that the Commission will take implementing measures in accordance with the comitology procedure.[229] The Committee of European Securities Regulators (CESR), which consists of representatives of the national regulatory and supervisory authorities, gives a technical opinion. On the basis of that opinion, the Commission prepares a draft implementing measure. The Commission submits it to the European Securities Committee (ESC), which gives its opinion.
- At Level 3, the CESR coordinates, informally, the activities of the national regulatory and supervisory authorities, with the aim of ensuring consistent, uniform implementation of the measures adopted at the first two levels.
- Level 4 involves the legislative and administrative implementation of Community law by the Member States, overseen by the European Commission.

The trend of international convergence of securities markets regulation is increased by international co-operation in this area. For example, IOSCO is a multilateral organisation of securities regulators. There is transatlantic Financial Markets Dialogue led by the European Commission and the SEC. Similarly, there is dialogue between the CESR and the SEC. The International Accounting Standards Board (IASB) is a key standard-setter for financial markets worldwide.[230]

Contents of the information management regime. The information management regime for listed companies consists of the following core duties:

- the duty to publish a prospectus (the Prospectus Directive);
- the duty to prepare annual accounts (the Fourth Directive) and consolidated accounts (the Seventh Directive);
- the duty to publish annual accounts, half-yearly financial reports, and interim management statements (the Transparency Directive);
- the duty to apply international accounting standards (IFRS, the IAS Regulation);
- the duty to carry out statutory audits on the basis of international auditing standards (Directive on statutory audits);
- ongoing disclosure obligations (the duty to disclose inside information) and restrictions on selective disclosure (the Directive on market abuse);
- restrictions on the use of inside information (the Directive on market abuse);

[229] Comitology refers to the procedures through which the Commission, in accordance with Article 202 of the EC Treaty, executes the powers conferred upon it to implement Community legislative acts under one of the decision-making procedures laid down by the EC Treaty (consultation, co-decision, cooperation and assent). The five comitology procedures (consultation, management, regulation, regulation with scrutiny and safeguard) are regulated by Council Decision 1999/468/EC, as amended by Decision 2006/512/EC, and oblige the Commission to submit draft implementing measures to a committee made up of Member State officials.

[230] See Alexander SK, Ferran E, Jackson HE, Moloney N, Transatlantic Financial Services Regulatory Dialogue, EBOLR 7 (2006) pp 647–673.

- the prohibition of market manipulation (the Directive on market abuse);
- the duty to disclose material holdings (the Transparency Directive and the Directive on takeover bids);
- the duty to disclose structural takeover defences (the Directive on takeover bids); and
- disclosure duties in the context of public takeover bids (the Directive on takeover bids).

The principle of home country control applies. The principle of home country control influences the governing law, as each competent authority will apply the law of its own country. Many questions will therefore be governed by the law of the country of incorporation.

This does not mean that issuers would not have any choice or that there would not be any regulatory competition.[231] It is easy for the firm to change its country of incorporation and the place of its legal seat (see Volume I).

Furthermore, the disclosure regime does not mean the harmonisation of Member States' choice of law rules or civil liability regimes (see section 5.9.8).

The Financial Services Action Plan. The mandatory information management regime was introduced by the Financial Services Action Plan (FSAP). The FSAP was a package of measures to establish a common financial disclosure regime across the EU for issuers of listed securities.

Its "disclosure and transparency agenda" consisted of the following legislative projects: the IAS Regulation; the Directive on Market Abuse which requires issuers to publish inside information; the Prospectus Directive which deals with initial disclosure requirements at the point of public offer of securities/its admission to trading on a regulated market; and the Transparency Directive. In addition to these legislative projects, the FSAP contained the Directive on statutory audits.

The FSAP was complemented by the Takeover Directive which lays down both disclosure requirements and conduct rules relating to mandatory or voluntary bids. For example, the Takeover Directive contains a "break-through rule" which seeks to limit the effect of restrictions on voting rights provided for in the articles of association of the target company or in contractual agreements.

Level of harmonisation, regulated markets. The FSAP has led to a high degree of harmonisation. Because of the use of "regulated markets" as a regulatory category, the mandatory information management regime applies to securities admitted to trading either on an "official" market regulated by the competent supervisory authority or on an "exchange-regulated" market regulated by the operator of the market. "Regulated markets" have been defined in the MiFID.[232] The MiFID authorises each Member State to confer the status of "regulated market" on markets which are constituted on its territory, comply with its regulations, and are notified to the Commission as a regulated market.[233]

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[231] For the absence of issuer choice, see See Moloney N, EC Securities Law. OUP, Oxford (2008) p 136.

[232] Article 4(1)(14) of Directive 2004/39/EC (MiFID).

[233] Article 47 of Directive 2004/39/EC (MiFID). See OJ C 057, 1 March 2008 pp 21–27.

Remaining differences. While the form and content of information that listed companies are required to produce have largely been harmonised, important differences remain.

First, not all markets are *regulated markets* and there are regulated markets with different listing requirements (see also section 5.9.2).

This can be illustrated by the Frankfurt, London, and Copenhagen stock exchanges. There are two main regulated markets in Frankfurt. There is one regulated market in London and Copenhagen.

In *Frankfurt*, issuers who prefer a regulated market[234] can choose either General Standard or its Prime Standard segment with increased reporting and transparency requirements (quarterly financial statements in English, corporate action timetable, analyst conference). While General Standard is designed to cut costs, Prime Standard is designed to attract international investors. (There are also regional stock exchanges in Germany.)

In the *London* market, a distinction is made between "listed" securities and other securities admitted to trading. The UK has made a policy decision to single out the officially listed segment of the securities market and to subject it to public regulation that extends beyond the minimum that is necessary to give effect to EU securities markets directives.[235]

In *Denmark*, Københavns Fondsbørs is a "regulated market" that falls within the full scope of the Community legal regime. Dansk Autoriseret Markedsplads (AMP) is a "regulated market" subject to a lighter regulatory regime but still governed by the same Community legal regime as Københavns Fondsbørs.[236]

In practice, exceptions to the duty to publish a prospectus under the Prospectus Directive (section 5.9.3) have played an important role in the emergence of *second-tier markets* with a lighter regulatory touch (for listing conditions, see section 5.9.2).[237] If a market is not a "regulated market" under the MiFID, admission to trading does not have to be subject to mandatory requirements to publish a prospectus (unless there is a public offering of securities)[238] or periodic disclosure requirements.

In *Frankfurt*, First Quotation Board (Open Market, Freiverkehr) and Entry Standard are unofficial markets regulated by Deutsche Börse AG (exchange-regulated markets). The Market Abuse Directive and provisions on public offerings apply to both. Compared with Open Market, Entry Standard is subject to additional transparency requirements.

In *London*, AIM is regulated by the London Stock Exchange plc and is therefore an exchange-regulated market rather than a "regulated market" under the MiFID. For example, AIM companies are not subject to disclosure requirements in respect of their compliance with the Combined Code on Corporate Governance.[239]

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[234] § 2(5) WpHG.

[235] It does so via provisions in the FSMA 2000 and associated regulations, and the Listing Rules, which are part of the FSA Handbook. Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) p 425.

[236] See Kaspersen H, Børsintroduktion på dansk AMP, NTS 2006:4 pp 110–122.

[237] See Alcock A, The Rise and Fall of UK Quoted Company Regulation, JBL 2007 pp 744–745.

[238] See Article 3(1) of Directive 2003/71/EC (Prospectus Directive).

[239] Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 428–429.

In *Copenhagen*, First North is an exchange-regulated market not regarded as a "regulated market" under the MIFiD.[240]

Second, *private companies* are basically not part of this regime. One could nevertheless say that the information management regime for listed companies "penetrates"[241] the separate legal personality of a listed company where a listed company must disclose information about a private company (its subsidiaries, affiliates or contract parties) or where a private company must disclose information about matters relating to a listed company or its shares (usually as a shareholder).

Third, it has largely been left open *by whom* (which organs, which people) financial information is to be produced. The duty to produce financial information depends largely on the regulation of corporate governance in each member State's company and capital market laws.

Fourth, checks and balances and the incentives to produce truthful information have not been harmonised. Generally, Member States may have addressed *agency* problems in different ways.

Fifth, the lack of harmonisation of core questions of *corporate governance* means that there is substantial variety in the way questions of corporate governance are handled by different Member States. For example, disclosure has traditionally been the most important principle of British company law, but German company law has traditionally relied on mandatory legal rules, structural measures, and mixed monitoring.

Sixth, there is variation between different Member States as regards the *level of discretion* left to companies to organise their internal affairs. There is also variation between companies within a single state.

For these reasons, the *reliability* of financial and other information published by companies can vary both between one Member State and another and between one company and another within a single state.

Periodic information. EU company law requires the publication of annual accounts (the Fourth Directive) and consolidated accounts (the Seventh Directive).

The Transparency Directive establishes requirements in relation to the disclosure of periodic and ongoing information about issuers whose securities are already admitted to trading on a regulated market situated or operating within a Member State.[242] The Transparency Directive requires those companies to publish *annual* and *semi-annual* reports. Although there is no obligation to publish quarterly reports (and the Transparency Directive is less demanding than the highest existing national standards which require quarterly reporting), there is a duty to publish *interim* management statements (which are broadly equivalent to quarterly

[240] See Kaspersen H, Børsintroduktion på dansk AMP, NTS 2006:4 pp 110–122.

[241] For the concept of penetration, see Chapter 2 of Mäntysaari P, Comparative Corporate Governance. Shareholders as a Rule-maker. Springer, Berlin Heidelberg (2005).

[242] Article 1(1) of Directive 2004/109/EC (Transparency Directive).

reports). Share issuers who already publish quarterly financial reports are not required to publish interim management statements.[243]

The annual and semi-annual reports are in effect mini-prospectuses. They must contain the audited (annual) or condensed (half-yearly) financial statements of the company, a management report and statements. These statements are made by the "persons responsible within the issuer" to the effect that, to the best of their knowledge, the financial statements prepared in accordance with the applicable set of accounting standards give a true and fair view.

The Transparency Directive also lays down a minimum standard of liability for the breach of these rules. Someone – at least the issuer or its administrative, management or supervisory bodies – must be responsible for the information to be drawn up and to be made public in accordance with the provisions of the Directive. Someone – either the issuer, its administrative, management or supervisory bodies or "persons responsible within the issuer" – must also be liable for failure to do so. Member States are free to determine the extent of this liability.

The Transparency Directive does not apply to companies whose shares have been admitted to trading on a market that is not regarded as a regulated market under Community law.

Accounting standards. Accounting standards have been dealt with in the Fourth and Seventh Company Law Directives and the International Accounting Standards (IAS) Regulation. They should partly improve the quality, comparability, and transparency of the financial information provided by companies, and partly ensure compatibility with international standards. The applicable accounting standards depend on the company.

If the company is governed by the law of a Member State and its securities are admitted to trading on a regulated market of any Member State, the company must use IFRS.[244] The IAS Regulation allows Member States to extend this requirement to all companies. In the US, listed companies are required to use the US GAAP. The SEC has recognised IFRS as adapted for the UK (UK IFRS). This can, in practice, cause multinational companies incorporated in the other Member States to keep two sets of books: one in US GAAP or the UK IFRS, and the other in the country's own IFRS. Different countries enforce and interpret the standards in different ways, which can reduce the comparability of financial statements.

If the company is governed by the law of a Member State and its securities are traded on a market that is not regarded as a regulated market under Community law, Community law does not require the use of IFRS. On the other hand, such a requirement could in principle be based on national law or the rules of the unregulated market.

Statutory audits. All statutory audits required by Community law should be carried out on the basis of international auditing standards.[245] The Accounting Directives require statutory audits unless the company is small.

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[243] Article 6 of Directive 2004/109/EC (Transparency Directive).

[244] Article 4 of Regulation 1606/2002 (IAS Regulation).

[245] See recital 13 and Article 26(1) of Directive 2006/43/EC (Directive on statutory audits).

The Directive on statutory audits[246] clarifies the duties of statutory auditors and sets out certain ethical principles to ensure their objectivity and independence. For example, the Directive contains provisions on: the introduction of an annual transparency report for audit firms; auditor rotation; audit quality reviews; the appointment of the statutory auditor or audit firm on the basis of a selection by the audit committee; and contacts between the statutory auditor and the audit committee.

Ongoing obligations to disclose information to the public. The most important rules on ad-hoc disclosure are based on the Market Abuse Directive and the Transparency Directive. The Listing Directive contains further rules on ad-hoc disclosure.

The issuer of securities admitted to trading on a regulated market in a Member State must disclose inside information to the public.[247] In some cases, disclosure of inside information may be delayed, provided that the delay would not be likely to mislead the public and the issuer is able to ensure the confidentiality of that information.[248] There are also rules on selective disclosure.[249]

The Listing Directive determines what information must be published in the listing particulars and provides for continuing obligations. As the Market Abuse Directive, the Listing Directive provides that "[t]he company must inform the public as soon as possible of any major new developments in its sphere of activity which are not public knowledge and which may, by virtue of their effect on its assets and liabilities or financial position or on the general course of its business, lead to substantial movements in the prices of its shares".[250]

According to the Transparency Directive, a person acquiring or disposing of shares so that its holding with a publicly traded company reaches, exceeds or falls below certain thresholds must inform the company. The company is in its turn responsible for disclosing that information to the public.[251]

The Transparency Directive also lays down a general obligation of the issuer to "ensure that all the facilities and information necessary to enable holders of shares to exercise their rights are available in the home Member State".[252] Like the Second Company Law Directive,[253] it also provides for the equal treatment of all holders of shares who are in the same position.[254]

Disclosure of information to shareholders. Shareholders are entitled to receive information about many transactions.

The Second, Third, and Sixth Company Law Directives, which apply generally to public limited-liability companies, the Directive on on cross-border mergers,

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[246] Directive 2006/43/EC (Directive on statutory audits).

[247] Article 6(1) of Directive 2003/6/EC (Directive on market abuse).

[248] Article 6(2) of Directive 2003/6/EC (Directive on market abuse). See also Article 3(1)(a) of Directive 2003/124/EC.

[249] Article 6(3) of Directive 2003/6/EC (Directive on market abuse). See also Article 3.

[250] Article 68(1) of Directive 2001/34/EC (Listing Directive).

[251] Article 9(1) of Directive 2004/109/EC (Transparency Directive).

[252] Article 13(2) of Directive 2004/109/EC (Transparency Directive).

[253] Article 42 of Directive 77/91/EEC (Second Company Law Directive).

[254] Article 13(1) of Directive 2004/109/EC (Transparency Directive).

which applies to all limited-liability companies, and the SE Regulation contain disclosure rules relating to transactions that must be approved by the general meeting (see above).

The Listing Directive provides that "[t]he listing particulars shall contain the information which, according to the particular nature of the issuer and of the securities for the admission of which application is being made, is necessary to enable investors and their investment advisers to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and of the rights attaching to such securities".[255]

The Directive on takeover bids provides for disclosure in the context of voluntary or mandatory takeover bids. The Directive applies where all or some of the securities covered by the bid have been admitted to trading on a regulated market.[256]

Summary. Many disclosure obligations therefore depend on the Member State and whether securities issued by the company are admitted to trading on a regulated market or an unregulated market. Some disclosure obligations apply to all companies.

5.9.2 Listing Conditions

General Remarks

Issuers must comply with listing rules when they apply for a listing. One of the most common requirements is the publication of a prospectus. There is not complete harmonisation of listing and prospectus rules in the EU. In particular, a market can be either a regulated market under Community law or an unregulated or exchange-regulated one, and different regulated markets can apply different listing conditions. This can be illustrated by the Frankfurt and London markets.

Frankfurt. In 2008, issuers on the Frankfurt Stock Exchange, the largest German stock exchange, were able to choose between a listing in Prime Standard, General Standard, Entry Standard, and Open Market.

The Open Market is not regarded as a regulated market under Community law. The Entry Standard is a segment of the Open Market. It is open to companies that want to include their shares in trading with reduced formal requirements. The legal framework of the Entry Standard is defined by the "General Terms and Conditions for the Regulated Unofficial Market". Issuers must comply with national provisions governing public offerings (WpPG, the German Securities Prospectus Act) and national insider trading rules (WpHG, the German Securities Trading Act). Entry Standard companies must publish audited annual financial statements, including a management report, within six months after the end of the reporting period. Financial statements must be prepared in accordance with national accounting standards (such as the HGB standard preferred by Mittelstand

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[255] Article 21(1) of Directive 2001/34/EC (Listing Directive).
[256] Article 1(1) of Directive 2004/25/EC (Directive on takeover bids).

companies) or IFRS or equivalent (national GAAP such as US GAAP or Japanese GAAP). In addition, they must publish interim reports and significant news items.

The General Standard is a regulated market under Community law. In the General Standard, transparency obligations are based on Community law. The statutory transparency regulations for EU-regulated markets cover, for example: audited annual financial statements, including management report and interim report in accordance with IFRS (BörsenZulV, BörsO); ad hoc disclosures (WpHG); publication of directors' dealings (WpHG); announcement of reporting thresholds (WpHG); and the making of a mandatory offer after change of control (WpÜG, the Securities Acquisition and Takeover Act).

The Prime Standard is designed for companies aiming at international visibility. Prime Standard companies must comply with additional transparency obligations compared with companies in the General Standard.[257] For example, they are obliged to prepare quarterly reports, publish a financial calendar and hold regular analysts' conferences. Prime Standard companies must report in English and in German.

London. The London Stock Exchange offers three separate markets: the Main Market, AIM, and Professional Securities Market (PSM).

AIM is a market designed for smaller companies. AIM is not regarded as a regulated market under Community law. It is regulated by the London Stock Exchance and has simplified admission requirements. For example, there is no prospectus requirement. The applicant must nevertheless produce an AIM admission document. The issuer must apply IFRS, but adherence to the Combined Code is on a voluntary basis.

PSM enables companies to raise capital through the issue of specialist securities such as debt and depositary rexeipts from professional or institutional investors. PSM is not regarded as a regulated market under Community law. It is regulated by the London Stock Exchange. There is no prospectus requirement under Community law. The applicant must nevertheless produce listing particulars for approval by the UK Listing Authority (UKLA). The issuer may apply national GAAP for financial reporting, and adherence to the Combined Code is on a voluntary basis.

A primary listing on the Main Market offers the highest level of protection to investors. The Main Market is a regulated market under Community law. One of the admission requirements is the production of a prospectus for approval by the UKLA. A comply or explain rule is mandatory for UK primary listed companies which are recommended to adhere to the Combined Code. The issuer must apply IFRS for financial reporting.

Listing is a term that applies to the Main Market and the PSM. A company must therefore apply to the UKLA (FSA) for admission to the Official List (a listing). Simultaneously it applies to the London Stock Exchange for admission of its securities to trading on the Main Market or PSM.

[257] According to Börsenordnung für die Frankfurter Wertpapierbörse.

Listing on a First-tier Market

According to EU securities markets law, a company must fulfil certain requirements before its shares can be admitted to trading on a regulated market. One could say that listing conditions and admission to trading rules can provide issuers with a means of signalling their basic credibility to investors.[258]

Overlapping requirements. The Listing Directive and the MiFID seemingly lay down overlapping requirements, and their mutual relationship is ambiguous.

The Listing Directive covers the "official listing" without defining the official listing concept. In the past, such a definition was not necessary as traditional stock exchanges were monopoly providers of listing services. That model became outdated as markets developed multiple trading segments and second-tier markets developed strongly.[259]

The official listing concept was replaced by the regulated market concept in later directives which formed the FSAP. However, the Listing Directive continued to apply.

It is unclear whether or not the Listing Directive requires Member States to apply a regime for "official listing" in the first place. The most important difference relates to authority to decide on admission (the competent public authority or the regulated market). As far as Community law is concerned, the same disclosure regime will apply in both cases, because the most important distinction is that between regulated markets and exchange-regulated markets.

Admission to listing, admission to trading. There is a distinction between admission to listing and admission to trading.

According to the Listing Directive, the "competent authority" will decide on the admission of securities to "official listing on a stock exchange".[260] The competent authorities are public authorities[261] such as the UK Listing Authority (the FSA, acting as the competent authority for listing) or the BaFin in Germany.[262] The "competent authorities" can reject an application for the admission of a security to listing where, in their opinion, the issuer's situation is such that admission would be detrimental to investors' interests.[263]

According to the MiFID, the authorisation to operate a regulated market even covers activities related to the admission of financial instruments to trading.[264] The MiFID provides that regulated markets decide on admission of financial instruments to trading.[265]

Substantive requirements under Community law. The Listing Directive and the MiFID contain substantive requirements. All Member States of the EU tend to

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258 See Moloney N, EC Securities Law. OUP, Oxford (2008) p 67.
259 Moloney N, EC Securities Law. OUP, Oxford (2008) pp 68–69.
260 Article 11(1) of Directive 2001/34/EC (Listing Directive).
261 Article 48(2) of Directive 2004/39/EC (MiFID).
262 Die Bundesanstalt für Finanzdienstleistungsaufsicht, the Federal Financial Supervisory Authority. See § 32 BörsG.
263 Article 11(2) of Directive 2001/34/EC (Listing Directive).
264 Recital 49 of Directive 2004/39/EC (MiFID).
265 See recital 49 of Directive 2004/39/EC (MiFID).

have similar requirements, because the Listing Directive is very detailed. A regulated market is nevertheless not prevented from applying more demanding requirements in respect of the issuers of securities or instruments which it is considering for admission to trading than are imposed pursuant to the MiFID and the Listing Directive.[266]

Substantive requirements under the Listing Directive. The Listing Directive sets out, for example, the following requirements: (a) The foreseeable market capitalisation of the shares for which admission to official listing is sought must usually be at least €1 million,[267] but Member States may provide for admission to official listing even when this condition is not fulfilled provided that the competent authorities are satisfied that there will be an adequate market for the shares concerned.[268] (b) The company must usually have published or filed its annual accounts in accordance with national law for the three financial years preceding the application for official listing.[269] (c) The shares must be freely negotiable.[270] (d) There is a rule on "free float". A sufficient number of shares must be distributed to the public, and a sufficient number of shares usually means at least 25% of the subscribed capital represented by the class of shares concerned.[271] (e) In addition, the company must ensure equal treatment for all shareholders who are in the same position.[272]

Where public issue precedes admission to official listing, the first listing may be made only after the end of the period during which subscription applications may be submitted.[273]

There is a general duty of disclosure. The Listing Directive provides that "[t]he listing particulars shall contain the information which, according to the particular nature of the issuer and of the securities for the admission of which application is being made, is necessary to enable investors and their investment advisers to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and of the rights attaching to such securities".[274] Another important source of disclosure duties is the Prospectus Directive.

Substantive requirements under the MiFID. The Listing Directive is complemented by the MiFID. Generally, the provisions of the MiFID concerning the admission of instruments to trading are without prejudice to the application of the Listing Directive.[275]

Member States have a duty to require "the regulated market to establish and maintain transparent and non-discriminatory rules, based on objective criteria,

[266] Recital 57 of Directive 2004/39/EC (MiFID); Article 8 of Directive 2001/34/EC (Listing Directive).
[267] Article 43(1) of Directive 2001/34/EC (Listing Directive).
[268] Article 43(2) of Directive 2001/34/EC (Listing Directive).
[269] Article 44 of Directive 2001/34/EC (Listing Directive).
[270] Article 46 of Directive 2001/34/EC (Listing Directive).
[271] Article 48 of Directive 2001/34/EC (Listing Directive).
[272] Article 66 of Directive 2001/34/EC (Listing Directive).
[273] Article 47 of Directive 2001/34/EC (Listing Directive).
[274] Article 21(1) of Directive 2001/34/EC (Listing Directive).
[275] Recital 57 of Directive 2004/39/EC (MiFID).

governing access to or membership of the regulated market".[276] Those rules shall ensure that any financial instruments admitted to trading in a regulated market "are capable of being traded in a fair, orderly and efficient manner and, in the case of transferable securities, are freely negotiable".[277]

Substantive requirements under the Prospectus Directive. The Prospectus Directive[278] requires the issuer to publish a prospectus when securities are either offered to the public or admitted to trading on a regulated market situated or operating within a Member State. The prospectus requirements will discussed below.

Listing on a Second-tier Market

Second-tier markets can be subject to a lighter regulatory framework, because many requirements based on Community law only apply to markets regarded as "regulated markets" under the MiFID and the Prospectus Directive contains exemption provisions. There is thus a distinction between "regulated markets" on one hand and "exchange-regulated markets" or "unofficial regulated markets" on the other.

London. For example, the Alternative Investment Market (AIM) of the London Stock Exchange (LSE) is not regarded as a "regulated market" under the MiFID.[279] AIM is nevertheless regarded as a market ("multilateral trading facility", MTF) even under the MiFID.[280] An MTF is regulated by its authorised operator.[281] This makes AIM an "exchange-regulated market" or a "regulated unofficial market" regulated by the London Stock Exchange.[282] This will change the power to decide on listing. According to the Listing Directive, the "competent authority" will decide on the admission of securities to "official listing on a stock exchange".[283] As AIM is not regarded as an "official list", the UKLA will not decide on admission to listing on AIM; only the LSE will as the authorised operator of AIM.

The introduction of the MiFID opened the European markets to competition, and new trading platforms entered the London market. They include in particular: Chi-X, a Multilateral Trading Facility (MTF) authorised and regulated by the

[276] Article 42(1) of Directive 2004/39/EC (MiFID).
[277] Article 40(1) of Directive 2004/39/EC (MiFID).
[278] Directive 2003/71/EC (Prospectus Directive).
[279] Article 4(1)(14) of Directive 2004/39/EC (MiFID).
[280] Article 4(1)(15) of Directive 2004/39/EC (MiFID). See also recital 6: "A market which is only composed of a set of rules that governs aspects related to membership, admission of instruments to trading, trading between members, reporting and, where applicable, transparency obligations is a regulated market or an MTF within the meaning of this Directive and the transactions concluded under those rules are considered to be concluded under the systems of a regulated market or an MTF …"
[281] Article 14 of Directive 2004/39/EC (MiFID). See also recital 49.
[282] See recital 49 of Directive 2004/39/EC (MiFID).
[283] Article 11(1) of Directive 2001/34/EC (Listing Directive).

UKLA/FSA and controlled by Nomura; BOAT, a bank joint venture that merely records off-exchange share trades;[284] and PLUS Markets, formerly known as Ofex.

Prospectus. Whether the issuer must produce a prospectus depends on whether there is a public offering. Issuers may benefit from exemptions under the Prospectus Directive (see below).

Primary and Secondary Listing

Issuers may list their securities on multiple exchanges. A company's main listing is referred to as its primary listing while subsequent listings on other exchanges are referred to as secondary listings. The vast majority of issuing companies obtain only a primary listing, invariably on a domestic exchange.

Single list for two or more national markets. On the other hand, the primary listing may be on a list that encompasses two or more regulated national markets. In this case, issuers choose an initial entry point for the listing of their securities.

Single passport and secondary listing in the EU. EU securities markets law makes it easier to obtain a second listing in another Member State.

The Prospectus Directive is based on the application of the country of origin principle and the principle of a "single European passport".[285] The obligation to publish a prospectus does not apply to the admission to trading on a regulated market of securities already admitted to trading on another regulated market provided that certain conditions have been met. One of the conditions is that a summary document is made available to the public in a language accepted by the competent authority of the Member State of the regulated market where admission is sought.[286] The secondary listing route can thus be used by a company wishing to "passport" its prospectus into another Member State.

Secondary listing without the consent of the issuer. A secondary listing can, in exceptional cases, happen even without the consent of the issuer. If a transferable security has been admitted to trading on a regulated market, it can subsequently be admitted to trading on other regulated markets. The issuer's consent is not necessary.[287]

Secondary listing in the US markets, registration. The legal and regulatory environment in the US has made it more difficult for the NYSE, Nasdaq, and other exchanges to compete for foreign companies' secondary listings.

US regulatory requirements and the US litigation environment are often perceived as too cumbersome and costly. For example, section 5 of the US Securities Act of 1933 provides that it is unlawful to make any public offer or sale of any security in the US without the prior filing of a registration statement and a

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[284] The MiFID lays down an obligation on a trader to execute orders, both on- and off-exchange, on terms most favourable to the client. Traders must be able to supply proof of best execution. See recital 44 of Directive 2004/39/EC (MiFID) as well as Article 21 (best execution) and Article 25 (reporting).

[285] Recitals 14 and 45 of Directive 2003/71/EC (Prospectus Directive).

[286] Article 4(2)(h) of Directive 2003/71/EC (Prospectus Directive). See also Article 38 of Directive 2001/34/EC (Listing Directive).

[287] Article 40(5) of Directive 2004/39/EC (MiFID).

prospectus with the SEC, and the Sarbanes-Oxley Act of 2002 imposes a stringent set of corporate governance, reporting and other requirements on companies listed in the US.

In practice, foreign issuers can benefit from important exemptions. International companies may seek access to the US market through private transactions that do not require listing or trading in the US public markets. The exemptions that are of most significance in relation to international equity offerings are: sales of securities outside the US (Regulation S); private placements (section 4(2) and Regulation D); and resales to qualified institutional buyers (Rule 144A).[288] Already in 2000, approximately 50% of the proceeds raised by international companies in the US were raised privately.[289]

5.9.3 Prospectus

The Prospectus Directive[290] determines the minimum and maximum contents of prospectuses that fall within its scope.

The Directive requires the issuer to publish a prospectus when securities are either offered to the public or admitted to trading on a regulated market situated or operating within a Member State. The main rule is thus that the Prospectus Directive applies in relation to all public offers and not only to those in respect of securities that are to be admitted to trading on a regulated market.

For example, a prospectus must be published: where a public offer is made on a primary market such as the Main Market of the LSE or Deutsche Börse's General Standard or Prime Standard; where a large public offer is made on a second-tier exchange-regulated market such as LSE's AIM or Deutsche Börse's Open Market or Entry Standard; where a takeover bid consists of an exchange offer pursuant to which the target's shareholders would receive shares in the bidder for their shares in the target (unless a document equivalent to that of the prospectus is available);[291] or where a private-equity firm makes an exit by offering a company's shares to the public in an IPO. All IPOs will prima facie fall within the scope of the mandatory prospectus requirement for public offers.

In the past, each country applied its own prospectus rules and the prospectus had to be approved by the authorities of many different countries. It was difficult to use the same prospectus in different countries, because each country had its own language requirements and even rules on the substance of the prospectus were different. The language requirements were a particular problem because of the time and effort it took to translate the documentation into different languages and the risk caused by different versions of same documents.

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[288] Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) p 501.
[289] Prospectus of NYSE Euronext, Inc., November 30, 2006, p 41.
[290] Directive 2003/71/EC (Prospectus Directive).
[291] For takeovers, see Articles 4(1)(b) of Directive 2003/71/EC (Prospectus Directive). For mergers, see Article 4(1)(c).

Now there are common rules on prospectuses. Like listing rules, the prospectus rules are based on many sources. The requirements for the drawing up, approval and distribution of the prospectus have been harmonised by the Prospectus Directive and an implementing Regulation which sets out the required contents of prospectuses in detail.[292] The implementing Regulation is an example of Level 2 legislation made under the Lamfalussy Process (section 5.9.1). The Committee of European Securities Regulators (CESR) has also issued recommendations for the consistent implementation of prospectus requirements.[293]

Benefits. The Prospectus Directive brings many benefits. The Directive makes it easier and cheaper for companies to raise capital throughout the EU by introducing the principle of a "single passport for issuers".[294] The Directive requires approval from a regulatory authority in one Member State (the issuer's "home competent authority") instead of regulatory authorities in many Member States. Furthermore, it provides that once approved by the authority in one Member State, a prospectus will have to be accepted everywhere else in the EU. Those rules have been made possible by the fact that the Directive also harmonises rules on the contents of prospectuses.

Duty to publish a prospectus, Community scope. The Prospectus Directive requires the publication of a prospectus: "Member States shall not allow any offer of securities to be made to the public within their territories without prior publication of a prospectus."[295]

No prospectus may be published until it has been approved by the competent authority of the home Member State.[296] In Germany, the competent authority is BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht, Federal Financial Supervisory Authority). In England, the competent authority is the Financial Services Authority (FSA) created by the Financial Services and Markets Act 2000 (FSMA). An approved prospectus has Community scope meaning that the prospectus approved by the home Member State is valid in any other Member State provided that certain notification requirements are complied with.[297]

No duty to publish a prospectus. However, the scope of the Prospectus Directive is limited in many ways. In some cases it is permitted to offer shares to investors without the publication of a prospectus. Those limitations are important in practice, because differences in prospectus requirements can give rise to the emergence of different markets.

First, the Directive does not apply to securities included in an offer where the total consideration of the offer is less than €2.5 million.

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[292] Regulation 809/2004 implementing Directive 2003/71/EC as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements.

[293] CESR, Recommendations for the Consistent Implementation of the European Commission's Regulation on Prospectuses, No 809/2004, CESR/05–054b (2005).

[294] Recital 14 of Directive 2003/71/EC (Prospectus Directive).

[295] Article 3(1) of Directive 2003/71/EC (Prospectus Directive).

[296] Article 13 of Directive 2003/71/EC (Prospectus Directive).

[297] Articles 17 and 18 of Directive 2003/71/EC (Prospectus Directive).

Second, the obligation to publish a prospectus does not apply to the following types of offer:[298] (a) offer of securities addressed solely to qualified investors; and/or (b) an offer of securities addressed to fewer than 100 natural or legal persons per Member State, other than qualified investors; and/or (c) an offer of securities addressed to investors who acquire securities for a total consideration of at least €50,000 per investor, for each separate offer; and/or (d) an offer of securities whose denomination per unit amounts to at least €50,000; and/or (e) an offer of securities with a total consideration of less than €100,000.

Third, there are also further exemptions from the obligation to publish a prospectus.[299] For example, there are exemptions that apply to: (a) securities offered in connection with a takeover by means of an exchange offer, provided that a document is available containing information which is regarded by the competent authority as being equivalent to that of the prospectus; and (b) securities offered, allotted or to be allotted in connection with a merger, provided that a document is available containing information which is regarded by the competent authority as being equivalent to that of the prospectus.

Qualified investors. The qualified investor exemption is one of the key exemptions under the Prospectus Directive because it facilitates a private-placement regime. Qualified investors are segmented into different categories which partly reflect the approach taken to segmenting retail and sophisticated investors under the MiFID. In addition to regulated entities[300] and certain public-sector entities,[301] it covers legal entities which are not SMEs[302] and, in rare cases, certain SMEs and natural persons.[303]

A legal entity is not regarded as an SME and is regarded as a qualified investor when it does not meet two of the following three criteria according to its last annual or consolidated accounts: an average number of employees during the financial year of less than 250; a total balance sheet not exceeding €43 million; and an annual net turnover not exceeding €50 million.

The qualified investor exemption does not apply to later resales by those qualified investors to the retail sector.[304] The resale regime has been described as "controversial".[305]

Non-prospectuses. Now, where an offer of securities is made, the issuer or offeror does not always have a duty to publish a prospectus under the Prospectus Directive. This does not mean that there is no duty of disclosure. Material information that is disclosed selectively must be disclosed to all investors to whom the offer is addressed (equality-of-access principle). Where a prospectus is

[298] Article 3(2) of Directive 2003/71/EC (Prospectus Directive).
[299] Article 4 of Directive 2003/71/EC (Prospectus Directive).
[300] Article 2(1)(e)(i) of Directive 2003/71/EC (Prospectus Directive).
[301] Article 2(1)(e)(ii) of Directive 2003/71/EC (Prospectus Directive).
[302] Article 2(1)(e)(iii) of Directive 2003/71/EC (Prospectus Directive)
[303] Article 2(1)(e)(iv-v) of Directive 2003/71/EC (Prospectus Directive).
[304] Article 3(2) of Directive 2003/71/EC (Prospectus Directive).
[305] Moloney N, EC Securities Law. OUP, Oxford (2008) p 142.

required to be published, such information must be included in the prospectus or in a supplement to the prospectus.[306]

Contents of the prospectus. The Directive lays down the main rules on the contents of the prospectus.[307]

The prospectus must contain all information which, according to the particular nature of the issuer and of the securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities.

This information must be presented in an easily analysable and comprehensible form.

The prospectus must contain four kinds of information: information concerning the issuer; information concerning the securities; a summary; and information about persons responsible.

The prospectus can be a single document or separate documents. Separate documents consist of three parts: a registration document; a securities note; and a summary note. There can also be a base prospectus for non-equity securities (for example, option rights are non-equity securities).[308]

The summary contains core information. It should generally not be longer than 2,500 words in its original language.[309] The summary must, in a brief manner and in non-technical language, convey the essential characteristics and risks associated with the issuer, any guarantor and the securities, in the language in which the prospectus was originally drawn up. The summary must also contain several risk warnings. Rules on the summary belong to the clearest examples of the Prospectus Directive's retail orientation.[310]

The summary is very important when the same prospectus is used in many Member States. Rules on the summary are complemented by an issuer-friendly language regime.[311] In the home Member State, the prospectus must always be drawn up in a language accepted by the competent authorities of that Member State. In host Member States, it is sufficient that the prospectus is drawn up "in a language customary in the sphere of international finance". In practice, this means English. The competent authority of each host Member State may then only require that the summary be translated into its official language(s). This is very practical, because it would be very difficult and expensive to start translating the whole prospectus (sometimes hundreds of pages) into the languages of many Member States.

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[306] Article 15(5) of Directive 2003/71/EC (Prospectus Directive). See Moloney N, EC Securities Law. OUP, Oxford (2008) p 135.

[307] Articles 5 and 6 of Directive 2003/71/EC (Prospectus Directive).

[308] Article 5(4) of Directive 2003/71/EC (Prospectus Directive).

[309] Recital 21 of Directive 2003/71/EC (Prospectus Directive).

[310] Moloney N, EC Securities Law. OUP, Oxford (2008) pp 144–145.

[311] For the language regime, see Mattil P, Möslein F, The language of the prospectus: Europeanisation and investor protection, BJIBFL 2008 pp 27–30.

Even the base prospectus for non-equity securities is important. The prospectus can, at the choice of the issuer, offeror, or person asking for the admission to trading on a regulated market, consist of a base prospectus. The base prospectus will then have to contain all relevant information concerning the issuer and the securities. The difference between a base prospectus and a normal one is that the information given in the base prospectus will be supplemented with updated information. The base prospectus makes it possible for issuers to react fast to market developments. Such a shelf-registration process was one of the Directive's most successful innovations.[312]

For example, issuers of so-called "certificates" (Zertifikat) on the German market tend to publish a base prospectus (Basisprospekt).[313] This has made the process of issuing those securities faster and increased both product development and the size of the certificates market.

The prospectus must contain information about persons responsible (for prospectus liability, see Volume I). The persons responsible for the prospectus must be clearly identified in the prospectus by their names and functions or, in the case of legal persons, their names and registered offices the persons responsible must declare that, to the best of their knowledge, the information contained in the prospectus is in accordance with the facts and that the prospectus makes no omission likely to affect its import. The summary is governed by a more limited civil-liability regime.[314]

Historical financial information, third country issuers. Historical financial information must generally be drawn up in accordance with IFRS. Third country issuers must prepare financial information in prospectuses according to IFRS or a third country's national accounting standards, provided that those standards are equivalent to IFRS. The Commission is required to set up a mechanism for the determination of the equivalence of the required information.[315] Regulation 1569/2007[316] lays down the conditions under which the GAAP of a third country may be considered equivalent to IFRS.[317] There is a transitional period.[318] US

312 Moloney N, EC Securities Law. OUP, Oxford (2008) p 146.

313 See 6 § of the Securities Prospectus Act (Wertpapierprospektgesetz, WpPG) and § 48a BörsZulV.

314 Article 5(2) of Directive 2003/71/EC (Prospectus Directive): "… The summary shall also contain a warning that: … (d) civil liability attaches to those persons who have tabled the summary including any translation thereof, and applied for its notification, but only if the summary is misleading, inaccurate or inconsistent when read together with the other parts of the prospectus …"

315 Article 23(4) of Directive 2004/109/EC (Transparency Directive).

316 Regulation 1569/2007 establishing a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities pursuant to Directives 2003/71/EC and 2004/109/EC.

317 Article 1 of Regulation 1569/2007.

318 Article 4 of Regulation 1569/2007.

GAAP, Japanese GAAP, and Canadian GAAP have been mentioned in the Regulation.[319]

Supplementary prospectus, withdrawal rights. If a new matter likely to influence the assessment of the investment arises after the publication of the prospectus but before the closing of the offer or the start of trading on a regulated market, a supplement to the prospectus must be published.[320] As said above, a base prospectus will be complemented by a supplementary prospectus.[321] A supplementary prospectus requires prior approval.

The Prospectus Directive provides that an investor must have particular withdrawal rights in certain circumstances when the price has been left open[322] or a supplementary prospectus has been published.[323]

Advertisements. There is a distinction between advertisements and prospectuses. An advertisement means "announcements: (a) relating to a specific offer to the public of securities or to an admission to trading on a regulated market; and (b) aiming to specifically promote the potential subscription or acquisition of securities."[324]

Advertisements do not require prior approval. However, advertisements must observe the following principles: advertisements must state that a prospectus has been or will be published and indicate where investors are or will be able to obtain it;[325] advertisements must be clearly recognisable as such;[326] the information contained in an advertisement must not be inaccurate or misleading; and all information must be consistent with the information contained in the prospectus.[327]

The Prospectus Directive does not grant a single European passport to advertising and host Member States remain empowered to impose requirements concerning advertising. For example, the Directive does not address the language of advertisements. This can increase translation costs and slow down the process.[328]

The process in practice. In traditional company law, it is often assumed that a company markets its shares directly to potential investors and that investors subscribe for new shares. In practice, however, the firm uses investment banks as intermediaries. The firm expects that those intermediaries: (a) possess know-how about the capital market, investors, and the pricing of securities; and (b) can take care of formalities. The most important steps of the issuing process will be described in section 5.10 below.

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[319] Recital 4 of Regulation 1569/2007. See also See Moloney N, EC Securities Law. OUP, Oxford (2008) pp 223–228.
[320] Article 16 and recital 34 of Directive 2003/71/EC (Prospectus Directive).
[321] Article 5(4) of Directive 2003/71/EC (Prospectus Directive).
[322] Article 8(1)(b) of Directive 2003/71/EC (Prospectus Directive).
[323] Article 16(2) of Directive 2003/71/EC (Prospectus Directive).
[324] Article 2(9) of Regulation 1787/2006.
[325] Article 15(2) of Directive 2003/71/EC (Prospectus Directive).
[326] Article 15(3) of Directive 2003/71/EC (Prospectus Directive).
[327] Articles 15(3) and 15(4) of Directive 2003/71/EC (Prospectus Directive).
[328] Moloney N, EC Securities Law. OUP, Oxford (2008) p 162.

5.9.4 Periodic and Ongoing Disclosure Obligations

Other disclosure requirements applicable to listed companies range from the periodic disclosure of financial information to ongoing disclosure obligations and the duty to disclose matters relating to corporate governance. This is a legal growth area.

Traditionally, disclosure has been the main principle of UK and US company and securities markets laws. Nowadays, extensive disclosure rules are not limited to the UK and US markets. There is extensive harmonisation of listed companies' disclosure requirements in the EU.

The Financial Services Action Plan contained measures to establish a common financial disclosure regime across the EU for issuers of listed securities (the "disclosure and transparency agenda"). Many of those measures were necessary because of the need to react to the extraterritorial scope of the Sarbanes-Oxley Act.

Periodic disclosure obligations. Listed companies must comply with a strict periodic disclosure regime that is based on EU directives and national law (see Volume I).

In addition to financial information, a listed company must disclose information about risk and corporate governance aspects on a regular basis (see below).

Ongoing disclosure obligations. Ad-hoc disclosure is regulated in particular by the Market Abuse Directive and the Transparency Directive. The Listing Directive contains further rules on ad-hoc disclosure. In addition, several directives deal with the disclosure of information relating to major transactions.

Any information that affects share price: the Market Abuse Directive. Disclosure is a traditional anti-insider dealing technique. Typical disclosure obligations which can mitigate the risk of insider dealing include the obligation to disclose managers' dealings,[329] the obligation to disclose beneficial ownership to shares,[330] and the obligation to disclose inside information.[331] The Directive on market abuse therefore not only prohibits abuse but also requires issuers to disclose information.

There is a general obligation to disclose all inside information to the public.[332] *Inside information* means "information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments".[333] Information is deemed to be of a *precise nature* if it "indicates a set of circumstances which exists or may reasonably be expected to come into existence or an

[329] Article 6(4) of Directive 2003/6/EC (Directive on market abuse) and Article 6 of Directive 2004/72/EC.

[330] Article 9(1) of Directive 2004/109/EC (Transparency Directive).

[331] Davies PL, Gower and Davies' Principles of Modern Company Law, Seventh Edition. Sweet & Maxwell, London (2003) pp 752–753.

[332] Article 6(1) of Directive 2003/6/EC (Directive on market abuse). The Listing Directive lays down a similar obligation. See Article 68(1) of Directive 2001/34/EC (Listing Directive).

[333] Article 1(1) of Directive 2003/6/EC (Directive on market abuse).

event which has occurred or may reasonably be expected to do so and if it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of financial instruments or related derivative financial instruments".[334] *Significant effect* depends on the issuer.[335] Information that would be likely to have a significant effect means "information a reasonable investor would be likely to use as part of the basis of his investment decisions".[336]

The issuer may delay the public disclosure of inside information, provided that: the issuer has a legitimate interest for doing so; delaying disclosure would not be likely to mislead the public; and the issuer is able to ensure the confidentiality of that information.[337] *Legitimate interests* for delaying public disclosure include, in particular, "negotiations in course, or related elements, where the outcome or normal pattern of those negotiations would be likely to be affected by public disclosure",[338] and "decisions taken or contracts made by the management body of an issuer which need the approval of another body of the issuer in order to become effective, where the organisation of such an issuer requires the separation between these bodies, provided that a public disclosure of the information before such approval together with the simultaneous announcement that this approval is still pending would jeopardise the correct assessment of the information by the public".[339] CESR has given little guidance on the nature of legitimate interests, because the right to delay the disclosure of inside information is a derogation from the general rule rather than the norm.[340]

This means that the firm must protect the *confidentiality* of inside information through internal "Chinese walls", other organisational measures, internal insider lists, project-specific insider lists, and non-disclosure agreements (NDA).[341] The firm can also benefit from statutory confidentiality obligations such as those applying to board members, auditors, and legal advisers.

Major transactions: duties under several Directives. Major transactions can trigger disclosure obligations under several Directives.

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[334] Article 1(1) of Directive 2003/124/EC. See also CESR, Market Abuse Directive. Level 3 – second set of CESR guidance and information on the common operation of the Directive to the market (July 2007).

[335] For English law, see DTR 2.2.4 (2): "In determining whether information would be likely to have a significant effect on the price of financial instruments, an issuer should be mindful that there is no figure (percentage change or otherwise) that can be set for any issuer when determining what constitutes a significant effect on the price of the financial instruments as this will vary from issuer to issuer."

[336] Article 1(2) of Directive 2003/124/EC.

[337] Article 6(2) of Directive 2003/6/EC (Directive on market abuse).

[338] Article 3(1)(a) of Directive 2003/124/EC.

[339] Article 3(1)(b) of Directive 2003/124/EC. See also Oberlandesgericht Stuttgart, judgment of 22.4.2009 (20 Kap 1/08) (the Schrempp case).

[340] CESR, Market Abuse Directive. Level 3 – second set of CESR guidance and information on the common operation of the Directive to the market (July 2007).

[341] See Article 3(2) of Directive 2003/124/EC.

Major transactions that affect share price can trigger disclosure obligations under the Market Abuse Directive and the Listing Directive.

Information must be disclosed to shareholders before the general meeting under the Second, Third and Sixth Company Law Directives,[342] the Directive on cross-border mergers[343] and the SE Regulation.[344] This is because many transactions relating to capital and structural change must be approved by the general meeting. The Transparency Directive also lays down a general obligation of the issuer to "ensure that all the facilities and information necessary to enable holders of shares to exercise their rights are available in the home Member State".[345]

Where a company offers shares to the public or applies for a stock exchange listing, many disclosure obligations will be triggered (see above) by provisions implementing the Prospectus Directive[346] and/or the Listing Directive.[347]

The Takeover Directive requires disclosure in the context of voluntary or mandatory takeover bids (sections 10.3.2 and 19.9).

Disclosure of major holdings: the Transparency Directive. The Transparency Directive lays down an obligation to disclose information about major holdings (section 19.3).

A person acquiring or disposing of shares so that its holding with a publicly traded company reaches, exceeds or falls below certain thresholds must inform the company, which is in its turn responsible for disclosing this information to the public. The thresholds are 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75% of voting rights.[348]

5.9.5 Disclosure of Risk

A listed company must disclose its risk factors and risk management policies (for a fuller account, see Volume I). Disclosure makes it easier for banks, shareholders and other investors to monitor the risk level of the firm. In the US, many of those disclosure obligations are based on the Sarbanes-Oxley Act.

Disclosure of risk factors. In the EU, the general disclosure of risk factors can be based on IFRS,[349] the Accounting Directives[350] and the Transparency Directive.[351] For example, the Transparency Directive requires issuers of listed securities to make a statement on risk in the annual financial report and in half-yearly fi-

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[342] Directives 77/91/EEC, 78/855/EEC, and 82/891/EEC.

[343] Directive 2005/56/EC on cross-border mergers of limited liability companies.

[344] Regulation 2157/2001 on the Statute for a European company (SE Regulation).

[345] Article 13(2) of Directive 2004/109/EC (Transparency Directive).

[346] Directive 2003/71/EC (Prospectus Directive).

[347] Directive 2001/34/EC (Listing Directive).

[348] Article 9(1) of Directive 2004/109/EC (Transparency Directive).

[349] See IAS 1.8, IAS 32 and IFRS 7.

[350] Article 46(2)(f) of Directive 78/660/EEC (as amended) and Article 36(2)(e) of Directive 83/349/EEC (as amended).

[351] See Articles 4(2), 5(2) and 5(4) of Directive 2004/109/EC (Transparency Directive).

nancial reports. In addition, the disclosure of risk factors is governed by Member States' national rules.

Disclosure of risk management policies. Section 404 of the Sarbanes-Oxley Act contains rules on management assessment of internal controls. In the EU, rules on the disclosure of the firm's risk management policies can be found in IFRS, the Accounting Directives, and many corporate governance codes. Such disclosure rules are often substantive rules in disguise (Volume I).

5.9.6 Disclosure of Corporate Governance Matters

In the EU, a listed company must disclose certain corporate governance aspects. Some disclosure obligations are based on stock exchange rules and corporate governance codes. However, some disclosure rules are based on legal instruments adopted by Community institutions.

Corporate governance statement. The Accounting Directives[352] provide that companies must issue an annual "corporate governance statement" in their annual report. That statement covers key issues such as whether the company complies with a corporate governance code, information about shareholders' meetings, and the composition and operation of the board and its committees.[353] The provisions concerning the corporate governance statement apply to "all companies, including banks, insurance and reinsurance undertakings and companies which have issued securities other than shares admitted to trading on a regulated market insofar as they are not exempted by Member States".[354]

The duty to issue a corporate governance statement is complemented by the statutory, contractual or voluntary duty to comply with a corporate governance code.

In *Germany*, the Aktiengesetz lays down a "comply or explain" obligation.[355] In *England*, "issuers" are required to comply with the Listing Rules (LR 1.1) which contain a reference to the Combined Code of Corporate Governance (LR 9.8.6). The Combined Code is not binding, but an issuer must: (a) apply the principles set out in Section 1[356] of the Combined Code and explain how they have been applied; and (b) either comply with the provisions set out in Section 1 of the Code provisions or give reasons for any non-compliance.

Internal controls. The consolidated accounts of a listed company must contain a description of the main features of the group's internal control and risk management systems in relation to the process for preparing consolidated accounts.[357] The

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[352] Article 46a of Directive 78/660/EEC, inserted by Article 1(7) of Directive 2006/46/EC.
[353] See recital 10 of Directive 2006/46/EC.
[354] Recital 11 of Directive 2006/46/EC.
[355] § 161 AktG.
[356] Section 1 applies to companies and Section 2 to institutional shareholders. Companies are not required to report on whether and how they have complied with the provisions set out in Section 2 of the Code.
[357] Article 36(2)(f) of Directive 83/349/EEC, inserted by Article 2(2) of Directive 2006/46/EC.

MiFID and Directive 2006/73 provide for a risk management regime for investment firms to which the MiFID applies (Volume I).

Disclosure of basic information about companies. Those duties are complemented by the duty to disclose basic information about the company. The most important rules can be found in the First and Second Company Law Directives.

The Second Company Law Directive lays down the minimum contents of the statutes of a limited liability company in the EU.[358] Many of these rules relate to shares and the share capital of the company.

The First Company Law Directive requires each Member State to maintain a central register, commercial register or companies register for limited liability companies. (a) The First Directive also provides for the compulsory disclosure of several documents. For example, companies must file the company's constitutional documents such as statutes or articles of association, and the balance sheet and profit and loss account for each financial year.[359] (b) All limited-liability companies must publish information about persons "who either as a body constituted pursuant to law or as members of any such body: (i) are authorised to represent the company in dealings with third parties and in legal proceedings; (ii) take part in the administration, supervision or control of the company".[360] However, the importance of information about these bodies varies between companies formed in different Member States because the role of statutory bodies in the management of the company depends on the law that governs the company, the size of the company, business culture, and other matters. (c) Third parties can obtain copies of documents or particulars filed by companies.[361] On the other, third parties are expected to have knowledge of information filed with the register and published. Third parties also have a right to rely on information published by the company in this way.[362]

According to the First Directive, a limited-liability company must also disclose its registration number and legal form in letters and order forms.[363]

5.9.7 Prohibition of Market Abuse

The prohibition of market abuse is an important part of the legal framework that applies to listed companies. The Directive on market abuse prohibits two main forms of market abuse: insider trading; and market manipulation. It has a wider scope compared with the directive it replaced.[364]

Scope. The scope of the Market Abuse Directive is governed by two concepts: financial instruments and regulated markets. The Directive applies where financial instruments are traded on a regulated market in the EU.

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[358] Articles 2 and 3 of Directive 77/91/EEC (Second Company Law Directive).
[359] Article 2 of Directive 68/151/EEC (First Company Law Directive).
[360] Article 2 of Directive 68/151/EEC (First Company Law Directive).
[361] Article 3 of Directive 68/151/EEC (First Company Law Directive).
[362] Article 3 of Directive 68/151/EEC (First Company Law Directive).
[363] Article 4 of Directive 68/151/EEC (First Company Law Directive).
[364] Directive 89/592/EEC (Insider Dealing Directive).

For example, it does not apply to the sale and purchase of the assets of a listed company (no financial instruments). Neither does it apply to the sale and purchase of shares of a listed company outside regulated markets (no trading on a regulated market).

Safe harbours under the Directive on market abuse are limited to stabilisation measures and share buy-backs.

Lamfalussy model. The Directive on market abuse was the first FSAP measure to follow the Lamfalussy model. The Market Abuse Directive takes the form of a level 1 Directive which is subject to delegated law-making at level 2 (Article 17).[365] CESR has adopted extensive level 3 guidance.[366]

Prohibition of insider trading. The laws of developed countries generally prohibit insider trading. However, the prohibition does not cover all use of non-public information. Where should the line be drawn?[367]

It is common to explain the scope of the prohibition by theories based on existing laws. For example, the concept of fiduciary duties is well-known in common law countries. The scope of the prohibition has therefore been explained by the existence of fiduciary relationships (fiduciary theory). In the US, section 10(b) of the Securities Exchange Act of 1934 is a general anti-fraud provision; to bring insider trading within the section makes it necessary to treat insider trading as a species of fraud (misappropriation theory).[368]

In Community law, the regulation of insider trading does not rest on any existing private law system. It is a transplant which cannot be explained by theories based on anti-fraud provisions or fiduciary duties.

According to the preamble of the Market Abuse Directive, the objective of legislation against insider dealing is: "to ensure the integrity of Community financial markets and to enhance investor confidence in those markets".[369]

The Directive on market abuse not only prohibits insider trading but also requires issuers to disclose information (section 5.9.4). This is reflected in the preamble, which states that insider dealing rules are designed to increase "full and proper market transparency, which is a prerequisite for trading for all economic actors in integrated financial markets".[370] Disclosure is a traditional anti-insider dealing technique. Typical disclosure obligations which can mitigate the risk of

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[365] Directive 2003/124/EC; Directive 2003/125/EC; Regulation 2273/2003; and Directive 2004/72/EC.

[366] See Moloney N, EC Securities Law. OUP, Oxford (2008) pp 919–923.

[367] See the early US cases of In the Matter of Cady, Roberts & Company and SEC v Texas Gulf Sulphur, 401 F. 2d 833 (2nd Circuit, 1968), cert. denied, 394 U.S. 976 (1969). Manne argued that insider trading actually benefited market efficiency. Henry Manne, Insider Trading and the Stock Market. The Free Press, New York (1966).

[368] SEC Rule 10b5–1 and Rule 10b5–2. United States v. O'Hagan, 117 S. Ct. 2199 (1997). For O'Hagan and Cady, Roberts, see Langevoort DC, Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation, Columbia L R 99 (1999) pp 1319–1343.

[369] Recital 12 of Directive 2003/6/EC (Directive on market abuse).

[370] Recital 15 of Directive 2003/6/EC (Directive on market abuse).

insider dealing include the obligation to draw up insider lists,[371] the obligation to disclose managers' dealings,[372] the obligation to disclose beneficial ownership to shares,[373] and the obligation to disclose inside information.[374]

One can say that the fundamental purpose of Community insider dealing and market manipulation rules is to *reduce* investors' *perceived risk* and *transaction costs*. Both can be reduced if investors generally believe that: issuers disclose to the public all information that is likely to have a significant effect on share price;[375] information disclosed to investors fulfils the requirement of generic usefulness (it is accurate, comprehensive and timely, see Volume I); all investors can have access to the same information;[376] all investors act in the market for legitimate reasons (requirement of fairness or good faith); and the rule that a party must not deal on the basis of inside information or manipulate the market is enforced effectively. The result is that the perceived "market integrity" is increased[377] and the financing costs are reduced for issuers.[378]

Now, the Market Abuse Directive prohibits insider dealing, but it does not prohibit the use of information which is not regarded as inside information. For example, information is not inside information if it has already been made public.[379]

Neither do the provisions on insider trading prohibit transactions in which inside information is not used. For example, the prohibition to use inside information does not apply to "transactions conducted in the discharge of an obligation that has become due to acquire or dispose of financial instruments where that obligation results from an agreement concluded before the person concerned possessed inside information".[380]

Information can be inside information only in the context of "one or more issuers of financial instruments" or "one or more financial instruments" to which it directly or indirectly "relates". "Relating" is a flexible concept. CESR's July 2007 Guidance contains a non-exhaustive and indicative list of information which directly or indirectly concerns the issuer.

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[371] Article 6(3) of Directive 2003/6/EC (Directive on market abuse) and Article 5 of Directive 2004/72/EC. Article 10 can lead to multiple and over-lapping insider-list obligations in different Member States. See Moloney N, EC Securities Law. OUP, Oxford (2008) pp 976–977.

[372] Article 6(4) of Directive 2003/6/EC (Directive on market abuse) and Article 6 of Directive 2004/72/EC.

[373] Article 9(1) of Directive 2004/109/EC (Transparency Directive).

[374] Davies PL, Gower and Davies' Principles of Modern Company Law, Seventh Edition. Sweet & Maxwell, London (2003) pp 752–753.

[375] Article 6(1) of Directive 2003/6/EC (Directive on market abuse).

[376] Articles 1(1) and 6(1) of Directive 2003/6/EC (Directive on market abuse); Articles 4, 5 and 6 of Directive 2004/109/EC (Transparency Directive); Articles 68(1) and 21(1) of Directive 2001/34/EC (Listing Directive).

[377] See already In the Matter of Cady, Roberts & Co., an early SEC case.

[378] See Bhattacharya U, Daouk H, The World Price of Insider Trading, J Fin 57 (2002) pp 75–108.

[379] Article 1(1) of Directive 2003/6/EC (Directive on market abuse).

[380] Article 2(3) of Directive 2003/6/EC (Directive on market abuse).

The prohibition covers many activities: the use of inside information by acquiring or disposing of financial instruments;[381] the unauthorised disclosure of inside information;[382] and the use of inside information by making recommendations.[383]

The prohibitions apply to primary insiders and secondary insiders. A primary insider is any person who possesses inside information: (a) by virtue of his membership of the administrative, management or supervisory bodies of the issuer; or (b) by virtue of his holding in the capital of the issuer; or (c) by virtue of his having access to the information through the exercise of his employment, profession or duties; or (d) by virtue of his criminal activities.[384] A secondary insider is any other person who possesses inside information while that person knows, or ought to have known, that it is inside information.[385]

The prohibitions apply both to natural persons and to legal persons. Where the person is a legal person, the prohibitions also apply to the natural persons who take part in the decision to carry out the transaction for the account of the legal person.[386]

Prohibition of market manipulation. The Market Abuse Directive provides for a catch all prohibition of market manipulation: "Member States shall prohibit any person from engaging in market manipulation."[387] While the rule that prohibits market manipulation is simple, the definition of market manipulation is more complicated.

The three basic forms of market manipulation contain: bad faith transactions which are likely to give false or misleading signals to the market; fictious or deceptive transactions; and dissemination of false or misleading information through the media.[388] The Directive lists usual examples of market manipulation.

In addition, the Commission gave several illustrative examples of market manipulation in 2001:[389]

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[381] Article 2 of Directive 2003/6/EC (Directive on market abuse).

[382] Article 3(a) of Directive 2003/6/EC (Directive on market abuse). See also C-384/02 Grøngaard and Bang [2005] ECR I-9939.

[383] Article 3(b) of Directive 2003/6/EC (Directive on market abuse).

[384] Article 2(1) of Directive 2003/6/EC (Directive on market abuse).

[385] Article 4 of Directive 2003/6/EC (Directive on market abuse).

[386] Article 2(2) of Directive 2003/6/EC (Directive on market abuse).

[387] Article 5 of Directive 2003/6/EC (Directive on market abuse).

[388] For a more precise definition, see Article 1(2) of Directive 2003/6/EC (Directive on market abuse).

[389] Proposal for a Directive of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), Explanatory Memorandum. OJ 240 E, 28 August 2001 pp 265–271. COM/2001/0281 final. COD 2001/0118.

Table 5.1 Examples of Market Manipulation

Trade-based actions intended to create a false impression of activity
Transactions in which there is no genuine change in actual ownership of the financial instruments ("wash sales").
Transactions where both buy and sell orders are entered at the same time, with the same price and quantity by different, but colluding parties ("improper matched orders").
Engaging in a series of transactions that are reported on a public display facility to give the impression of activity or price movement in a financial instrument ("painting the tape").
Engaging in an activity designed by a person or persons acting in collaboration to push the price of a financial instrument to an artificially high level (pumping the financial instruments on the market) and then to sell its or their own financial instruments massively ("pumping and dumping").
Increasing the bid for a financial instrument to increase its price (creating the impression of strength or the illusion that stock activity was causing the increase) ("advancing the bid").

Trade-based actions intended to create a shortage
Securing such a control of the bid or demand-side of the derivative and/or the underlying asset that the manipulator has a dominant position which can be exploited to manipulate the price of the derivative and/or the underlying asset ("cornering").
Like "cornering" taking advantage of a shortage in an asset by controlling the demand-side and exploiting market congestion during such shortages in such a way as to create artificial prices. Having significant influence over supply or delivery, having the right to require delivery and using that to dictate arbitrary and abnormal prices ("abusive squeezes").

Time-specific trade-based actions
Buying or selling financial instruments at the close of the market in an effort to alter the closing price of the financial instrument and therefore misleading those acting on the basis of closing prices ("marking the close").
Trading specifically to interfere with the spot or settlement price of derivative contracts.
Trading to influence the particular spot price for a financial instrument that had been agreed as determining the value of a transaction.

Information-related actions

Purchasing a financial instrument for one's own account before recommending it to others and then selling it at a profit on the rise in the price following the recommendation ("scalping").[390]

Spreading false rumours to induce buying or selling by others.

Making untrue statements of material facts.

Non-disclosure of material facts or material interests.

Directive 2003/124/EC sets out a non-exclusive list of non-exhaustive signals which should be taken into account when transactions or orders to trade are examined by market participants and competent authorities.[391]

On the other hand, a CERS Guidance identifies accepted market practices.[392] An important defence to a finding of market manipulation applies where the person establishes that: his reasons were legitimate; and the transactions or orders to trade conform to accepted market practices on the regulated market concerned. This can raise difficult questions of fact and proof.[393]

Effect on share buybacks and stabilisation. The general prohibition of insider trading and market manipulation could, in principle, cover share buybacks (inside information) and the stabilisation of share price (market manipulation). Many forms of share buybacks and price stabilisation are nevertheless regarded as acceptable forms of market behavior. There is an exemption for these two forms of market behaviour if certain conditions are met.

According to the Market Abuse Directive, the prohibition of market abuse will not apply to trading in own shares in buy-back programmes or to the stabilisation of a financial instrument "provided such trading is carried out in accordance with implementing measures adopted in accordance with the procedure laid down in Article 17(2)".[394] The Commission has taken those "implementing measures". A Commission Regulation sets out in detail how share buyback programmes and price stabilisation can be compatible with the Market Abuse Directive.[395]

There are similar rules in the US. Rule 10b-18 under the Securities Exchange Act of 1934 provides issuers with a qualified safe harbour from liability for market manipulation when

[390] For an example of scalping in Germany, see BGHSt 48, 373 = NJW 2004, 302.
[391] Articles 4–5 of Directive 2003/124/EC.
[392] CESR, Market Abuse Directive. Level 3 – first set of CESR guidance and information on the common operation of the Directive (May 2005).
[393] Moloney N, EC Securities Law. OUP, Oxford (2008) p 986.
[394] Article 8 of Directive 2003/6/EC (Directive on market abuse).
[395] Regulation 2273/2003 implementing Directive 2003/6/EC as regards exemptions for buy-back programmes and stabilisation of financial instruments.

they repurchase their common stock in accordance with the rule's timing, price, manner of purchase and volume conditions.[396]

Whistle-blowing. The Directive on market abuse requires a whistle-blowing obligation. Any person professionally arranging transactions in financial instruments who reasonably suspects that a transaction might constitute insider dealing or market manipulation must notify the competent authority without delay.[397]

5.9.8 Enforcement

Rules on the enforcement of securities markets laws have only to a limited extent been approximated at Community level. The allocation of responsibility for compliance can depend on the regulation of corporate governance in the Member State in question, and sanctions for the breach of duty largely depend on the governing law.

The Member States have different approaches to sanctions in this area.[398] Each Member State has adopted its own mix of civil, administrative, and criminal sanctions. As a minimum requirement, sanctions should be "effective, proportionate and dissuasive". There is no room for an analysis of different approaches to sanctions in the Member States here.

There can also be differences depending on the context: prospectus liability, liability for financial information, liability for ad-hoc disclosure, and market abuse have been regulated separately even in Community law.

Prospectuses and listing particulars. The "persons responsible" must be clearly identified in the prospectus.[399] Member States must ensure that their laws, regulations and administrative provisions on civil liability apply to those persons responsible for the information given in a prospectus.[400]

Member States must ensure that "the appropriate administrative measures can be taken or administrative sanctions be imposed against the persons responsible, where the provisions adopted in the implementation of this Directive have not been complied with. Member States shall ensure that these measures are effective, proportionate and dissuasive." This is without prejudice to the right of Member

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[396] See, for example, Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice. New York City (2008) pp 157–158.

[397] Article 6(9) of Directive 2003/6/EC (Directive on market abuse). See also CESR, Market Abuse Directive. Level 3 – first set of CESR guidance and information on the common operation of the Directive (May 2005).

[398] See, for example, CESR, Report on Administrative Measures and Sanctions as well as the Criminal Sanctions available in Member States under the Market Abuse Directive (28 February 2008).

[399] Article 6(1) of Directive 2003/71/EC (Prospectus Directive).

[400] Article 6(2) of Directive 2003/71/EC (Prospectus Directive).

States "to impose criminal sanctions and without prejudice to their civil liability regime".[401]

Periodic information. After the amendment of the Fourth and Seventh Company Law Directives,[402] the "administrative, management and supervisory bodies" of a company are, as a minimum requirement, collectively responsible for drawing up and publishing annual accounts and annual reports.[403] Typically, all board members are collectively responsible for financial statements and key non-financial information and all board members are held accountable for their actions and proper conduct of their responsibilities. Again, sanctions for breach of duty are based on national law. The minimum requirement is that penalties for infringements are "effective, proportionate and dissuasive".[404]

Statements under the Transparency Directive must be made by "persons responsible within the issuer".[405] They should also be liable for the breach of disclosure obligations based on the Transparency Directive.[406]

Ad-hoc disclosure, takeovers. As regards ad-hoc disclosure, Member States have a duty to designate the categories of persons that are responsible. Sanctions for non-compliance must be "effective, proportionate and dissuasive".[407] In the context of public takeover bids, the boards of the participating companies have certain disclosure duties.[408]

Risk management, governing law and international jurisdiction. The issuer can reduce risk by trying to comply with provisions of the governing law, by avoiding the scope of certain countries' laws; and by limiting the legal relevance of disclosed information in other ways (for compliance and information management, see Volume I).

The most important connecting factor on the basis of which the governing law, the jurisdiction of supervisory authorities, and the international jurisdiction of courts are determined according to FSAP directives is the *home Member State* of the issuer. However, there are even other connecting factors.

Governing law. The principle of home country control influences the question of governing law, as each competent authority applies the law of its own country.

As a rule, the issuer's home Member State is the connecting factor for issuer disclosure according to FSAP directives. As regards prospectuses, the home Member State of the issuer is thus regarded as the one best placed to regulate the

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[401] Article 25(1) of Directive 2003/71/EC (Prospectus Directive).

[402] Directive 2006/46/EC.

[403] Article 50b of Directive 78/660/EEC (Fourth Company Law Directive), inserted by Article 1(8) of Directive 2006/46/EC.

[404] Article 60a of Directive 78/660/EEC, inserted by Article 1(10) of Directive 2006/46/EC. See already Article 6 of the Directive 68/151/EEC (First Company Law Directive).

[405] Articles 4(2)(c) and Article 5(2)(c) of Directive 2004/109/EC (Transparency Directive).

[406] Article 7 of Directive 2004/109/EC (Transparency Directive). See also Article 24.

[407] Article 14(1) of Directive 2003/6/EC (Directive on market abuse).

[408] For sanctions, see Article 17 of Directive 2004/25/EC (Directive on takeover bids).

matter.[409] A Community issuer can influence the governing law by choosing where to have its registered office.[410]

There can nevertheless be particular connecting factors. According to the Directive on market abuse, each Member State must apply the prohibitions and requirements provided for in the Market Abuse Directive to actions carried out on its territory (or abroad, where the actions concern financial instruments admitted to trading on a regulated market situated or operating within its territory).[411] The Directive is silent on the governing law. The choice of law rules of the forum can therefore play a role. (a) In principle, they can refer to the law of the home Member State. The Directive does not prohibit the application of the laws of the issuer's home Member State even in host Member States (see above). (b) According to traditional choice of law rules, however, each competent authority will apply the law of its own country. In this case, the most important connecting factor applicable to ongoing disclosure obligations under the Market Abuse Directive would be the Member State on the territory of which actions are or should be carried out. (c) In order to prevent circumvention, the Market Abuse Directive requires Member States' competent authorities to co-operate.[412]

Furthermore, one can distinguish between the law governing disclosure obligations and the law governing the civil liability for their breach. Generally, FSAP directives are without prejudice to Member States' civil liability regimes and do not designate the law governing such questions. Typically, company law questions will be governed by the law governing the company (*Inspire Art*).[413] Questions of non-contractual liability arising out of a tort or delict will usually be governed by the law of the country in which the damage occurs, unless the tort/delict is manifestly more closely connected with another country.[414]

According to Swiss law, prospectus liability is governed by the law governing the issuer or the law of the country in which the securities have been issued to the public.[415]

International jurisdiction. The question of governing law should be distinguished from the question of the international jurisdiction of courts. The issuer cannot exclude the potential jurisdiction of other Member States' courts without adapting its actions and limiting them to certain jurisdictions.

As regards civil liability for periodical information and liability for ad-hoc disclosures to the capital market, the issuer cannot exclude the potential jurisdiction of other Member States' courts. This can be illustrated by the Transparency Direc-

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[409] Recital 14 of Directive 2003/71/EC (Prospectus Directive).

[410] Article 2(1)(m) of Directive 2003/71/EC (Prospectus Directive).

[411] Article 10 of Directive 2003/6/EC (Directive on market abuse). See also Moloney N, EC Securities Law. OUP, Oxford (2008) pp 969–970.

[412] See, in particular, Article 16(3) of Directive 2003/6/EC (Directive on market abuse).

[413] Case C-167/01 Inspire Art [2003] ECR I-10155, paragraphs 97 and 100. See also Article 1(2)(d) of Regulation 864/2007 (Rome II).

[414] Article 4 of Regulation 864/2007 (Rome II).

[415] Art. 156 IPRG. For prospectus liability in Switzerland generally, see Roberto V, Wegmann T, Prospekthaftung in der Schweiz, SZW/RSDA 73 (2001) pp 161–178.

tive. The Transparency Directive sets "high-level requirements in the area of dissemination of regulated information" and requires "active distribution of information from the issuers to the media, with a view to reaching investors". This is "necessary to ensure that investors, even if situated in a Member State other than that of the issuer, have equal access to regulated information". Furthermore, "regulated information should be disseminated in a way that ensures the widest possible public access, and where possible reaching the public simultaneously inside and outside the issuer's home Member State".[416] Typically, the issuer and its representatives can thus be sued either in their own home Member State or States[417] or, alternatively, in any other Member State (place of harmful event or place of consequential damage)[418] to the extent that a plaintiff has sustained damage in that state.[419]

Prospectus liability is governed by the same rules. The issuer and its representatives can thus be sued in civil law cases either in their own home Member State or a Member State where the offer was made and the prospectus published (place of harmful event or place of consequential damage).

5.9.9 Delisting

Delisting means that securities admitted to trading on a certain market will cease to be admitted to listing and trading on that market. If those securities will not remain admitted to trading on any market, delisting is part of a going private transaction.

Reason to delist securities or to go private. There can be many reasons to delist securities or to go private. The main reasons include: the cost of maintaining a listing; the fear of class actions in the US; and increased flexibility after going private.

A stock exchange listing – especially a first-tier listing – can be expensive. In addition to the direct costs of listing, the firm must incur compliance costs. For some firms, the costs of maintaining a listing outweigh the benefits.

The costs are higher in the case of multiple listings, that is, where securities issued by the firm are listed in more than one venue. For example, Nokia shares were traded only on the Helsinki Exchanges and the NYSE in 2008. The Nokia share has been delisted from the London Stock Exchange, the Frankfurt Stock Exchange, the Stockholm Stock Exchange, and the Paris Stock Exchange, because most of the trading took place on the Helsinki Exchanges.

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[416] Recitals 15–17 of Directive 2007/14/EC.

[417] Article 2(1) of Regulation 44/2001 (Brussels I Regulation).

[418] Article 5(3) of Regulation 44/2001 (Brussels I Regulation); Case 21/76 Mines de Potasse d'Alsace [1976] ECR 1735. See also Article 6.

[419] Case C-68/93 Fiona Shevill, Ixora Trading Inc., Chequepoint SARL and Chequepoint International Ltd v Presse Alliance SA C-68/93 [1995] ECR I-415.

US securities market laws – in particular the Sarbanes-Oxley Act – and the risk of class actions have put off many foreign companies from listing in the US and increased delistings.

Some firms are taken private following a takeover. For example, a controlling shareholder will obtain legal benefits by taking take the firm private (Volume I), and going private enables private-equity firms to refinance and/or restructure the target without public scrutiny (section 10.5). The value of going private transactions has grown in recent years.

It is also possible that either the firm or its shares issued have ceased to fulfil the current requirements of a stock exchange listing.

Structure of going private transactions. A going private transaction typically consists of the following steps. A public offer is made for securities issued by the company. A voluntary offer can be followed by a mandatory bid under mandatory provisions of law implementing the Directive on takeover bids,[420] other mandatory provisions of law,[421] stock exchange rules, or the target company's articles of association. After the threshold of voting rights that gives the controlling shareholder a squeeze-out right has been reached,[422] the controlling shareholder will ensure that the company will take internal action to decide on delisting and then apply for delisting.[423] After delisting, the squeeze-out mechanism will be used to acquire the outstanding securities.

Legal constraints on delisting. Delisting is constrained by legal rules necessary for the protection of minority shareholders. A delisting always means that the liquidity of shares will suffer. This will have a negative effect on share price, as it becomes more difficult for the remaining shareholders to sell their shares. The terms of delisting depend on the governing law and the securities exchange. Delisting rules have only partly been approximated by the provisions of EU securities markets law.

In practice, the firm should take into account even other aspects before delisting its securities. There may be contractual constraints. Although an issuer might be eligible to delist its securities, it should review its various contractual obligations to ensure that it is not otherwise obliged to remain listed (or, in the US, registered with the SEC). In particular, an issuer considering delisting should verify that doing so will not trigger any events of default or violate any covenants under its contracts.

Three ways to delist securities. There are basically three ways to delist securities. First, the issuer can apply for a delisting (regular delisting). Second, the legal entity that has issued the securities can cease to exist. Third, the securities can be delisted either by the operator of the securities exchange or the competent author-

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[420] See nevertheless Article 5(2) of Directive 2004/25/EC (Directive on takeover bids).

[421] Article 3(2) of Directive 2004/25/EC (Directive on takeover bids).

[422] Article 15 of Directive 2004/25/EC (Directive on takeover bids). For German law, see § 327a AktG and § 39a WpÜG (Wertpapiererwerbs- und Übernahmegesetz, Securities Acquisition and Takeover Act).

[423] For Nordic law, see Kaspersen H, Om reguleringen af Going Private transaktioner, NTS 2003:3 pp 328–342; Kristiansson B, Avnotering efter ansökan av bolaget, NTS 2006:3 pp 32–44.

ity because the securities or the issuer no more fulfil the listing requirements or because the issuer has breached its obligations.

Regular delisting. Regular delisting is governed by rules that regulate the internal decision-making of the company and rules which regulate the protection of investors.

Where delisting is part of a going private transaction, the rules governing public offers, mandatory bids, the squeeze-out mechanisms, and other parts of the going private transaction will require disclosure of information to shareholders and possibly the convening of a general meeting. Depending on the market, stock exchange rules and codes of conduct applicable to issuers will lay down further requirements.

Typically, regular delisting is a *management* matter. The main rule therefore should be that the consent of shareholders in general meeting is not required. There can nevertheless be exceptions, because a delisting can reduce the value of shares. A resolution by the *general meeting* is required under both English and German law.

In *England*, an issuer that wants the FSA to cancel the listing of any of its equity shares with a primary listing must: (1) send a circular to the holders of the securities; and (2) obtain, at a general meeting, the prior approval of a resolution for the cancellation of the listing by a qualified majority of not less than 75% of votes.[424]An issuer is not required to seek the prior approval of the holders of the ordinary equity shares for which a cancellation is being sought if the shares are admitted to trading on a regulated market in an EEA State when the cancellation takes effect.[425] According to *German* company law, a regular delisting restricts the transferability of shares and violates the ownership rights of non-controlling shareholders. A regular delisting must therefore be decided on by the general meeting with a simple majority of votes and requires the making of a mandatory bid. Minority shareholders must be entitled to the full value of their shares.[426]

When a regular delisting is decided on by the general meeting, minority shareholders will get access to remedies that protect them against resolutions that do not comply with the applicable provisions of company law or the articles of assocation.

In any case, regular delisting at the issuer's request is constrained by other rules protecting investors. Delisting typically requires the consent of the *competent authority* that decided on admission to listing (or the *operator* of the regulated market that decided on admission to trading, see section 5.9.2). An important condition is that delisting will not prejudice the interests of investors. Delisting would prejudice their interests if normal dealings in the securities are possible before delisting.[427]

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[424] LR 5.2.5 R.

[425] LR 5.2.6 R.

[426] BGH, judgment of 25.11.2002 – II ZR 133/01 (Ingram/Macrotron), referring to Article 14(1) of the German Grundgesetz.

[427] Article 18(2) of Directive 2001/34/EC (Listing Directive). For German law, see § 39 BörsG (Börsengesetz, Stock Exchange Act). For English law, see LR 5.2.1 R.

One of the special circumstances that preclude normal regular dealings is ownership concentration. A shareholder can reduce the number of outstanding shares and increase the prospects of a delisting through a public offer.

For example, the FSA may cancel the listing of shares "if the percentage of shares in public hands falls below 25% or such lower percentage as the FSA may permit".[428]

The exact modalities of a regular delisting depend not only on the governing law but also on the rules of the market. There are disclosure obligations which can resemble the disclosure obligations applicable to public offers.[429] The exact requirements can vary depending on the market.

For example, the Düsseldorf Stock Exchange applies stricter rules than the Frankfurt Stock Exchange although both are governed by German law. The requirements of the Frankfurt Stock Exchange can be fulfilled by disclosing the delisting six months in advance so that "investors have sufficient time to sell".[430] The Düsseldorf Stock Exchange requires the making of a mandatory bid to holders of outstanding shares.[431] The Federal Supreme Court (BGH) held in the *Macrotron* case[432] that the majority shareholder must make a mandatory offer for outstanding shares.

Issuer ceases to exist. Securities must be delisted where the legal entity that issued them ceases to exist. For example, shares can disappear as a result of a merger.

Non-compliance with the rules of the market. The MiFID makes it easier to delist securities that do not fulfil the minimum requirements of listing.

Either the operator of the regulated market or the competent authority may decide to "suspend or remove from trading a financial instrument which no longer complies with the rules of the regulated market unless such a step would be likely to cause significant damage to the investors' interests or the orderly functioning of the market".[433]

SEC. In 2007, the SEC issued a release adopting new rules on "deregistration".[434] The SEC established two alternative quantitative benchmarks for the deregistration of the equity securities of foreign private issuers: (i) a new trading

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[428] LR 5.2.2 G. See also SEC Rule 13e-3, Going Private Transactions by Certain Issuers or Their Affiliates.

[429] Such rules can have been inspired by SEC Rule 13e-3, Going Private Transactions by Certain Issuers or Their Affiliates.

[430] § 58(1)(2) and § 58(2) of Börsenordnung der Frankfurter Wertpapierbörse (Exchange Rules for the Frankfurt Stock Exchange).

[431] § 74(4) of Börsenordnung der Börse Düsseldorf. The bid must fulfil the requirements of § 31 WpÜG.

[432] BGH, judgment of 25.11.2002 – II ZR 133/01 (Ingram/Macrotron).

[433] Article 41 of Directive 2004/39/EC (MiFID). See also Articles 17, 18 and 19 of Directive 2001/34/EC (Listing Directive). For German law, see § 38 BörsG. For English law, see LR 5.2.2 G.

[434] SEC Release No. 34–55540, "Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934" (March 27, 2007).

volume benchmark (the average daily trading volume of the subject class of its securities in the United States has been five percent or less of the worldwide average daily trading volume of such securities for a recent twelve-month period) and (ii) a revised version of the 300-holder benchmark contained in the prior rules (it has less than 300 record holders on a worldwide basis or who are US residents).

5.10 Shares as a Source of Cash

5.10.1 General Remarks

Shares can be offered to investors in a number ways. New shares can be offered for subscription. Existing shares can be offered for sale. Both new and existing shares can be offered to the public or placed. Alternatively, the offer can be made to intermediaries that allocate the shares to their own clients.[435]

Shares can be issued for cash for many reasons. This reflects the fact that shareholders can be providers of funding and/or ancillary services. (a) For example, the company may want to cement a business relationship (and the provision of "ancillary services") through the issuing of shares to a strategic investor who subscribes for shares in order to obtain private business benefits. (b) The company may need fresh capital or more equity capital, and existing shareholders, a financial investor, or a venture capital firm may be regarded as suitable sources of funding. (c) The issuing of new shares for cash and increasing the number of shareholders can also be the first step towards existing shareholders' exit. An initial public offering (IPO) will often be executed through the issue of new shares for a cash consideration to new investors.

The issuing of shares for cash raises many questions of company and securities markets law. For example, provisions of company law address questions of internal decision-making, the price payable for the shares, and verification of payment. If applicable, provisions of securities markets law set out extensive disclosure duties.

Company law. The European legal capital regime applicable to all public limited-liability companies means that the use of shares as a source of cash is generally constrained by mandatory provisions of law protecting shareholders and creditors.

Many questions relating to shares and legal capital are therefore *decided on by shareholders*. According to the Second Company Law Directive, the general meeting decides on "any increase in capital"[436] and the authorisation of a company body to decide on an increase in the "subscribed capital".[437]

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[435] See Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 419–420.
[436] Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).
[437] Article 25(2) of Directive 77/91/EEC (Second Company Law Directive).

Existing shareholders have *pre-emption rights*.[438] There is a minimum statutory period for the pre-emptive offer.[439] The Second Directive provides that the general meeting decides on the withdrawal of shareholders right of pre-emption[440] or the authorisation of a company body to decide on it.[441] According to the Second Directive, pre-emption rights do not have to apply in relation to the sale of paid-up shares (no increase in capital), allotment of bonus shares (no consideration), shares paid up otherwise than in cash (not consideration in cash), or shares under an employees' share scheme (employee exemption).[442]

Because of such exemptions, pre-emption rights can be circumvented by, for example, vendor placing or the use of the cashbox structure.

Ferran has described vendor placing and the cashbox structure as methods to circumvent existing shareholders' pre-emption rights as follows: "In a vendor placing, the purchaser technically allots new shares to the vendor as consideration for the asset acquired, thereby coming within the non-cash exemption from pre-emption rights, but the new shares are then immediately sold in the market on the vendor's behalf with the result that the vendor receives the cash proceeds of the new issue. The ultimate outcome is thus that the vendor receives cash in return for the asset it has sold without the company having to go to its shareholders for it or for permission to raise it on a non pre-emptive basis."[443] "One step beyond the vendor placing is the 'cashbox' structure where a third party vendor has no direct involvement in the contractual structure. In a cashbox structure, the company in need of funds (Issuer) extablishes a Newco and an offer of Newco ordinary and preference shares is made to an intermediary bank. The bank gives an undertaking to pay the subscription price (X). The bank then agrees to transfer the Newco ordinary and preference shares to Issuer in consideration for the allotment of shares in Issuer to placees found by the bank. The placing made by the Issuer is thus an issue for non-cash consideration. The bank then pays X to Newco and the Issuer can thereafter extract it, for example by redeeming the preference shares or by an intra-group loan. Cashbox structures tend to be utilized in conjunction with an acquisition."[444]

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[438] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive): "Whenever the capital is increased by consideration in cash, the shares must be offered on a pre-emptive basis to shareholders in proportion to the capital represented by their shares."

[439] Article 29(3) of Directive 77/91/EEC (Second Company Law Directive): "… The right of pre-emption must be exercised within a period which shall not be less than 14 days from the date of publication of the offer or from the date of dispatch of the letters to the shareholders."

[440] Article 29(4) of Directive 77/91/EEC (Second Company Law Directive).

[441] Article 29(5) of Directive 77/91/EEC (Second Company Law Directive).

[442] For English law, see Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) p 138.

[443] Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) p 139. For UK offering structures, see Myners P, The impact of shareholders' pre-emption rights on a public company's ability to raise new capital. An invitation to comment from Paul Myners (3 November 2004).

[444] Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 139–140, referring to Wippell M, Stuart A, Cash Box Structures: Uses and Implications, Practical Law for Companies 16(6) (2004).

In addition, the Second Directive prohibits the issuing of shares "at a price lower than their *nominal value*, or, where there is no nominal value, their *accountable par*".[445] There is an exemption making it easier to use intermediaries: Member States may allow those who undertake to place shares in the exercise of their profession to pay less than the total price of the shares for which they subscribe in the course of this transaction.[446]

When determining the issue price, the firm will have to take into account the legal capital regime. The Second Directive does not require *share premiums* to be treated in the same way as fixed share capital. Depending on the preferences of the Member State and the articles of association of the company, they can more easily be distributed to shareholders.[447] Sums representing share premiums represent a valuable source of funding.

Securities markets law. Offers of shares to the public and issues by companies whose securities have been admitted to trading are constrained by rules based on EU securities markets law (see section 5.9).

The process in practice: general remarks. In company law, it is assumed that a company markets its shares to potential investors and that investors directly subscribe for new shares. Such a simple process would be sufficient in a private placement by an SME.

However, a listed company, or a company that wants its securities to be admitted to trading on a regulated market in an IPO, would use one or more investment banks as intermediaries. The company expects them to: (a) possess know-how about the capital market, investors, and the pricing of securities; and (b) ensure that all formalities will be taken care of; and (c) work as a risk mitigation mechanism.

The process can be complicated. In the following, the key steps of the process will therefore be illustrated by the 2006 IPO of Ahlstrom Corporation, a Finnish manufacturer of specialty papers. The Ahlstrom IPO can be regarded as a mainstream European IPO which involved the use of the most common legal techniques and practices.

5.10.2 Management of Risk

In an IPO, the firm typically employs a mix of methods to obtain a higher price for its shares and to manage risk.

Choice of an investment bank or banks. A usual IPO starts with a "beauty contest" and the choice of an investment bank.

A letter of engagement will describe: the transaction; the services that the investment bank will provide (possibly as lead bank in a consortium); the role of

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[445] Article 8(1) of Directive 77/91/EEC (Second Company Law Directive).

[446] Article 8(2) of Directive 77/91/EEC (Second Company Law Directive).

[447] Article 15(1)(a) of Directive 77/91/EEC (Second Company Law Directive): "… lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes." See, for example, Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 116–123.

other advisers; the duties of the issuer (for example, participation in a due diligence); the fees; and how the contract can be terminated.

The issuer will also have to choose how shares will be subscribed for. There are various flotation methods. It is common that a bank or a consortium will subscribe for shares and sell them to the public.[448] In that case, the issuer and the lead bank will have to choose a consortium of other participating banks.

In the Ahlstrom IPO, SEB Enskilda, a Swedish bank, acted as global coordinator, lead manager and bookrunner. Calyon, a French bank, and Opstock, a subsidiary of a Finnish bank, acted as co-lead managers.

In the US, the most common way of raising equity is to use an underwriter. Tirole describes the procedure as follows:[449] "The underwriter may guarantee the proceeds of the shares in case of undersubscription; the underwriter can then sell the unsold shares at a lower, but not at a higher, price than the price stated in the public offering. This is the 'firm commitment' contract institution. The risk borne by the underwriter is limited, though, if, as is often the case, the price is fixed shortly before the offering. By contrast, under a 'best efforts' contract, the underwriter does not bear the risk of offer failure; and the offer is withdrawn if a minimum sales level is not reached within a specified amount of time."

Pricing method. The issuer will always have to choose a pricing method. While traditional company law rules tend to be based on the assumption that a *fixed price* is payable for shares, other methods are used in modern business practice.

One of the most common methods is "*bookbuilding*". The bookbuilding method includes the following steps: preliminary pricing of securities during the pre-marketing phase (meaning that important investors will be interviewed); choice of a price range (instead of a fixed price); marketing measures and roadshows; order taking (institutional and private investors may order a certain amount of shares and choose the price they are prepared to pay); and closing.

In the Ahlstrom IPO, the offering consisted of two parts because of the bookbuilding method. The Institutional Offering to Finnish and international institutional investors comprised initially 7,300,000 shares. The Retail Offering to retail investors in Finland comprised initially 700,000 shares. The initial offer price range was €20.00–24.00 per share.

Method of signalling lower price risk. The choice of a pricing method is complemented by the choice of methods that signal a lower price risk to potential investors. The same methods help the issuer to ensure that the IPO will succeed.

The firm will usually try to ensure that the subscription price is not too low and that there will not be a rapid short-term price rise when trading begins. The firm will also try to ensure that the subscription price is not too high in the light of market changes and that the share price will not collapse soon after trading has begun.

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[448] See Article 8(2) of Directive 77/91/EEC (Second Company Law Directive).

[449] Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) pp 94–95.

One of the purposes of the *bookbuilding* method is to signal to investors that the offer price is reasonable. As said above, this is done by interviewing institutional investors about the price during the pre-marketing phase.

The share price can be *stabilised* by means of an over-allotment option (the greenshoe method), a share buy-back programme, and lock-ups.

An *over-allotment option* (the greenshoe method) can mitigate the risk of price rises caused by too large demand. The terms of the over-allotment option are constrained by the Directive on market abuse. In practice, they must comply with the detailed provisions of the legal instruments implementing the Directive.[450] There is a Commission Regulation implementing the Market Abuse Directive as regards exemptions for buy-back programmes and stabilisation of financial instruments.[451]

In the Ahlstrom IPO, Ahlstrom disclosed[452] that SEB Enskilda, a Swedish bank, was granted an option,[453] exercisable for 30 days[454] from the date of pre-listing of the shares on the Helsinki Stock exchange, to subscribe for up to 1,150,000[455] additional new shares (in addition to the offering of 8,000,000 new ordinary shares to the public) at the offer price,[456] solely to cover over-allotments.[457]

A share *buy-back programme* can help the firm to stabilise the price and mitigate the risk of decreasing share price caused by too much selling.

In addition, large institutional investors will accept a *lock-up clause* that will prohibit insiders from making short-term profits and causing the share price to fall soon after trading has begun.

The combination of those methods helps the firm to signal a more stable development of the share price, avoid very short-term investors, attract investors whose investment period is longer, and obtain a better price for its shares.

Stabilisation and market abuse. From a legal perspective, stabilisation nevertheless raises questions of market abuse (for share buy-backs and stabilisation, see also section 10.2.4).

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[450] Article 8 of Directive 2003/6/EC (Directive on market abuse).

[451] Regulation 2273/2003 implementing Directive 2003/6/EC as regards exemptions for buy-back programmes and stabilisation of financial instruments.

[452] Article 9(1) of Regulation 2273/2003.

[453] Article 2 of Regulation 2273/2003: "For the purposes of this Regulation, the following definitions shall apply in addition to those laid down in Directive 2003/6/EC: … 14. 'greenshoe option' means an option granted by the offeror in favour of the investment firm(s) or credit institution(s) involved in the offer for the purpose of covering overallotments, under the terms of which such firm(s) or institution(s) may purchase up to a certain amount of relevant securities at the offer price for a certain period of time after the offer of the relevant securities ..."

[454] See Article 8(2) of Regulation 2273/2003.

[455] Article 11(d) of Regulation 2273/2003.

[456] Article 11(a) of Regulation 2273/2003, see also Article 10(1).

[457] Article 11(c) of Regulation 2273/2003.

Stabilisation will not always be deemed to constitute market abuse.[458] Some forms of stabilisation can "contribute to greater confidence of investors and issuers in the financial markets" and therefore be compatible with Community law.[459] However, behaviour which is not directly related to that purpose is considered as any other action and may thus be prohibited.

In practice, only such modalities of the greenshoe method and the buy-back programme should be used which comply with the exact terms set out in the Directive on market abuse[460] and implementing legislation, in particular Regulation 2273/2003. Regulation 2273/2003 lays down the permitted conditions for "ancillary stabilisation".[461] For example, whereas the issuer will always decide on the limits of stabilisation measures, the decision to actually take those measures should be left to an investment bank rather than the issuer.

Due diligence. There is often a due diligence inspection of the issuer by the investment bank. The investment bank requires a due diligence for three particular reasons (for risk management in general, see Volume I).

First, the investment bank cannot fulfil its obligations without useful information. A due diligence helps the investment bank fulfil its obligations.

Second, the investment bank must carry out a due diligence in order to mitigate its own risk of prospectus liability. According to rules on prospectus liability, persons who are responsible for the prospectus are also responsible for its truthfulness and completeness. Prospectus liability is based on the Prospectus Directive.[462]

Third, the investment bank should try to protect its reputation. (Whether those who work for the investment bank actually have a vested interest in the bank's long-term reputation may depend on personal incentives. In practice, it may be based on fees generated by deals.)

In addition to a due diligence, the investment bank will need the co-operation of the issuer's management when the prospectus and other documents are drafted. Drafting of a prospectus usually requires many drafting sessions with the issuer's management.

Drafting of an offering circular. An offering circular (also called an offering memorandum) can be prepared when no prospectus is required. An offering circular can be used in private placements or when neither the Prospectus Directive nor provisions of Member States' laws implementing it require the publication of a prospectus.

For example, the publication of a prospectus is not required for offers limited to qualified investors. In contrast, any resale to the public or public trading through admission to trading on a regulated market requires the publication of a prospectus.[463]

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[458] Recital 2 of Regulation 2273/2003.
[459] Recital 11 of Regulation 2273/2003.
[460] See Article 8 of Directive 2003/6/EC (Directive on market abuse).
[461] Article 11 of Regulation 2273/2003.
[462] Articles 6(1) and 6(2) of Directive 2003/71/EC (Prospectus Directive).
[463] Recital 16 of Directive 2003/71/EC (Prospectus Directive).

On the other hand, the publication of an offering circular is not always optional. There can also be a duty to make it public. This is because the Prospectus Directive requires the publication of similar information even where it does not require the publication of a prospectus: "… material information provided by an issuer or an offeror and addressed to qualified investors or special categories of investors, including information disclosed in the context of meetings relating to offers of securities, shall be disclosed to all qualified investors or special categories of investors to whom the offer is exclusively addressed …"[464]

In the Ahlstrom IPO, part of the offering consisted of an offering to institutional investors and a private placement. An offering circular was prepared. Because of prospectus rules, the offering circular could only be distributed to certain recipients and could not be made public.

The Offering Circular contained restrictions the purpose of which was to: ensure compliance with EU prospectus rules; benefit from exemptions under the Prospectus Directive;[465] and make recipients of the Offering Circular responsible for checking that they qualified as institutional investors and did not take any action that would trigger a duty to publish a prospectus under the Prospectus Directive.[466]

The recipients of the Offering Circular were prohibited from using the information for any other purpose than to consider purchasing or subscribing for the Offer Shares. In the light of the Directive on market abuse, a listed issuer would have had to agree on confidentiality because of the obligation to disclose any inside information disclosed to a third party who does not owe a confidentiality obligation.[467]

In addition, it contained legal waivers made necessary by Member States' national laws and non-member states' laws such as the US Securities Act.[468]

Drafting of a prospectus. The Prospectus Directive provides that (a) Member States shall not allow any offer of securities to be made to the public within their

[464] Article 15(5) of Directive 2003/71/EC (Prospectus Directive).

[465] Article 3 and 4 of Directive 2003/71/EC (Prospectus Directive). Article 2 sets out the scope of the Directive.

[466] Ahlstrom Corporation, Offering Circular (13 March 2006): "This Offering Circular has been prepared on the basis that all offers of Offer Shares other than the offer contemplated in the Finnish Prospectus will be made pursuant to an exemption under the Prospectus Directive … Accordingly, any person making or intending to make any offer within the EEA of Offer Shares which is the subject of the placement contemplated in this Offering Circular should only do so in circumstances in which no obligation arises for the Company or any of the Managers to produce a prospectus for such offer … Each person in a Member State of the EEA … who receives any communication in respect of, or who acquires any Offer Shares under, the offers contemplated in this Offering Circular will be deemed to have represented, warranted and agreed to and with each Manager and the Company that: (a) it is a qualified investor …"

[467] Article 6(3) of Directive 2003/6/EC (Directive on market abuse).

[468] The Offering Circular contained, for example, the following statement (in capital letters): "The Offer Shares have not been and will not registered under the U.S. Securities Act or any state securities laws, and may not be offered or sold within the United States or to U.S. persons except to qualified institutional buyers in reliance on the exemption from the registration requirements of the U.S. Securities Act provided by Rule 144A and outside the United States in compliance with Regulation S …"

territories without prior publication of a prospectus and that (b) Member States shall ensure that any admission of securities to trading on a regulated market situated or operating within their territories is subject to the publication of a prospectus.[469]

The prospectus may not be published until it has been approved by the competent authority of the home Member State according to the home-country principle.[470] The home Member State means usually the Member State where the issuer has its registered office.[471]

For this reason, Ahlstrom had to draft a prospectus before making the IPO and before shares issued by it could be admitted to trading on the Helsinki Stock Exchange.

In the EU, the contents of regulated prospectuses are, to a large extent, based on a Regulation implementing the Prospectus Directive.[472] The Prospectus Regulation: specifies the *contents* of prospectuses (which can be drawn up either as a single document or composed of three separate documents); lays down rules on the publication of the *additional information* which the Prospectus Directive requires to be published outside the prospectus itself; sets out the conditions issuers must meet when making information available by referring (in the prospectus) to other *documents published previously or simultaneously*; and includes requirements on how such documents must be *published* and *advertised* (in order to ensure that interested parties have adequate access to the prospectus).

Where the issuer or offeror has provided material information to qualified investors or special categories of investors in the context of meetings relating to the offer or otherwise, the *same information* must be included in the prospectus or in a supplement to the prospectus.[473]

In the Ahlstrom IPO, the Offering Circular that was originally confidental and distributed to banks and institutional investors was thereafter made available to all investors.

Publication of a prospectus. The Prospectus Directive and implementing legislation set out how a prospectus can be published once approved.[474]

Drafting of advertisements and information concerning the offer. All information concerning the IPO disclosed in an oral or written form must be consistent with that contained in the prospectus.[475]Advertisements must state that a

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[469] Articles 3(1) and 3(3) of Directive 2003/71/EC (Prospectus Directive).

[470] Articles 3(1) and 13(1) of Directive 2003/71/EC (Prospectus Directive).

[471] Articles 2(1)(m)(i) of Directive 2003/71/EC (Prospectus Directive).

[472] Regulation 809/2004 implementing Directive 2003/71/EC as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements.

[473] Article 15(5) of Directive 2003/71/EC (Prospectus Directive).

[474] Article 14 of Directive 2003/71/EC (Prospectus Directive).

[475] Article 15(4) of Directive 2003/71/EC (Prospectus Directive).

prospectus has been or will be published and indicate where investors are or will be able to obtain it.[476]

For example, it was stated in the Offering Circular distributed by Ahlstrom that the Offering Circular was "an advertisement for the purposes of the Prospectus Directive" and that a "prospectus prepared pursuant to applicable legislation governing the public offering of securities in Finland" had been published in Finland.

Waivers. The prospectus, advertisements and other information concerning the offer will contain several legal waivers.

As regards the largely unregulated advertisements and offering circulars, banks and issuers have more discretion to draft waivers.

If the prospectus falls within the scope of the Prospectus Directive, its legal meaning, its contents, the responsibility for its contents, and the liability for its breach are governed by detailed rules, which means that the parties have less discretion to draft waivers.

In practice, however, the study of unregulated offering circulars and regulated prospectuses reveals that, apart from some exceptions, banks and issuers tend to use similar waivers in both cases.

Waivers in the offering circular. Waivers serve many purposes. In the Ahlstrom IPO, the main purposes of waivers in the Offering Circular were to: keep, to the extent possible, the Offering Circular outside the scope of the provisions of Finnish, European and US securities markets laws; adapt the Offering Circular to those (mandatory) provisions of securities markets laws that applied anyway; ensure that the Offering Circular did not create any offer to sell where it would have been unlawful; transfer the responsibility to ensure compliance with mandatory laws to prospective purchasers of shares; exclude the legal relevance of any other information; dilute the legal relevance of information contained in the Offering Circular; transfer the responsibility for the usefulness of information contained in the Offering Circular to potential purchasers of shares; exclude the liability of the manager banks that drafted it; and limit the liability of the issuer and its representatives.

The Offering Circular was kept *outside the scope* of certain provisions of Finnish, European and US securities markets laws by making it a condition that the issuer benefited from exemptions under the potentially applicable securities markets laws (the Prospectus Directive, national laws implementing the provisions of the Prospectus Directive, and the US Securities Markets Act).

In any case, it was necessary to *adapt* the Offering Circular to potentially applicable provisions of securities markets laws by adapting its scope to those exemptions and by

[476] Article 15(2) of Directive 2003/71/EC (Prospectus Directive).

making statements to all investors, US investors,[477] New Hampshire residents,[478] and UK investors.[479]

In addition, it was stated that the Offering Circular did not create any offer to sell or a solicitation of offers to buy where it is *unlawful*.

The responsibility to *ensure compliance* with mandatory laws was transferred to prospective purchasers of shares in three ways. First, the Offering Circular contained general statements on the transfer of responsibility to potential purchasers. Second, the Offering Circular contained a general prohibition to offer or sell shares or to distribute the Offering Circular when it was unlawful. Third, prospective purchasers had a special responsibility to ensure that exemptions under the Prospectus Directive (or under Rule 144A under the US Securities Act) applied to them in order to make sure that no oligation to publish a prospectus was triggered.

The *legal relevance* of any other information was *excluded* in two main ways. First, it was stated that nobody had a right to give any information on behalf of the issuer and managers other than as contained in the Offering Circular and that any such information must not be relied upon. Second, it was stated that any decision to purchase any Offer Shares should be based solely on the Offering Circular.

The legal relevance of information contained in the Offering Circular was *diluted* in a number of ways. The following list contains some of the most common statements. First, the Offering Circular was identified as an advertisement under the Prospectus Directive and it was stated that a prospectus was to be published.[480] Second, it was stated that the Offering Circular did not contain all the information that would be included in a prospectus under the Prospectus Directive or the US Securities Act. Third, the manager banks excluded their reponsibility for the accuracy or completeness of the information in the Offering Circular. Fourth, the Offering Circular identified many statements as forward-looking statements for which the issuer undertook no liability. Fifth, it was stated that the contents of the Offering Circular were for information purposes only and should not be construed as legal, accounting or tax advice. Sixth, it was said that the facts had already changed after the date of the Offering Circular. Seventh, it was stated that prospective investors must rely on their own examination of Ahlstrom and the terms of the offering, including the merits and risks involved. Eighth, some of the information was repeated in bold letters.

Responsibility for the *usefulness of information* was transferred to potential purchasers of shares in two ways. It was transferred de facto through dilution of the legal relevance of information (see above). In addition, it was expressly stated that in making an investment decision, prospective investors must rely on their own examination of Ahlstrom and the terms of the offering.

The *liability* of the manager banks was *excluded*. This was clearly stated in the Offering Circular: "The Managers make no representation or warranty, express or implied, as to the accuracy or completeness of the information in this Offering Circular, and nothing in this Offering Circular is, or shall be relied upon as, a promise or representation by the Managers."

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[477] Reference was made to Rules 144, 144A and 144A(d)(4) under the US Securities Act, Sections 13 and 15(d) of the US Securities Exchange Act, and Rule 12g3–2(b) under the US Securities Exchange Act.

[478] Reference was made to Chapter 421–B of the New Hampshire Revised Statutes.

[479] Reference was made to Articles 19(5) and 49(2)(a) to (d) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005.

[480] Articles 15(2) and 15(3) of Directive 2003/71/EC (Prospectus Directive).

The issuer was identified as the *party responsible* for the Offering Circular.[481] However, the liability of the issuer was limited in two ways. (a) It was de facto limited through terms that sought to dilute the legal relevance of information contained in the Offering Circular. (b) In addition, the issuer could benefit from provisions of Finnish law according to which it is very difficult to make the issuer liable to subscribers of shares. The Offering Circular contained a choice of law clause according to which the Offering was governed by Finnish law, and the issuer was a company incorporated in Finland and thus governed by Finnish company laws. The Offering Circular did not contain any rules that would have restricted the application of provisions of Finnish law as regards liability for omissions or misstatements in prospectuses.

Without being identified as responsible for the Offering Circular, several persons signalled that they had verified its contents or information on which it was based. They included the board of directors of the issuer as well as auditors that had submitted reports to the issuer's shareholders.

Waivers in the prospectus. The prospectus typically contains the same waivers as the offering circular. A prospectus intended to fulfil all requirements set out in the Prospectus Directive and implementing legislation will not contain any references to exemptions under the Prospectus Directive.[482]

In the Ahlstrom IPO, the prospectus was drafted in connection with an offer of shares to the public. Unlike the Offering Circular, the prospectus contained no references to exemptions under the Prospectus Directive.

Commencement of the Institutional Offering. The Prospectus Directive does not set out when an offering which does not fall within the scope of the Directive may commence. For example, the Prospectus Directive does not require an offering circular used instead of a prospectus to be approved by the supervisory authority. In practice, this means that an institutional offering may commence before a retail offering.

In the Ahlstrom IPO, the Institutional Offering commenced on 27 February 2006 and ended on 13 March 2006.

Applying for a listing. If the Prospectus Directive does require the publication of a prospectus, it must be submitted to the competent authority for approval.

After the approval of the prospectus by the competent authority (in the Ahlstrom IPO, the Finnish Financial Supervision Authority), Ahlstrom could apply for the admission of its shares to official listing on the Helsinki Stock Exchange. The competent authority to decide on admission to listing[483] was the board of the Helsinki Stock Exchange. One of the conditions of admission to listing was

[481] Persons responsible would have been identified in a regulated prospectus under the Prospectus Directive. Article 6(1) of Directive 2003/71/EC (Prospectus Directive).

[482] See Article 3 of Directive 2003/71/EC (Prospectus Directive).

[483] Articles 11 and 105 of Directive 2001/34/EC (Listing Directive); Article 48 of Directive 2004/39/EC (MiFID).

the conclusion of a contract between the Stock Exchange and the issuer.[484] Ahlstrom submitted its application for admission on 1 March 2006.

Commencement of the Retail Offering. On 1 March 2006, after the prospectus was published, Ahlstrom could also offer its shares to the public. The Retail Offering thus commenced on 1 March 2006. It ended on 9 March 2006.

Fixing the number of shares and price. Ahlstrom made the final decision on the number of shares to be offered for subscription and the offer price after the expiry of the marketing period in the Institutional Offering. This happened on 13 March 2006.

Ahlstrom Corporation decided to issue a total of 8,000,000 of its shares in its initial public offering. Both the institutional offering and the retail offering were priced at €22.00 per share. Although Community law does not require the same price for all securities of the same class issued by the company, it makes commercial sense to charge the same price from institutional investors and retail investors (for the purposes of the bookbuilding method, see above).

Admission to listing and commencement of trading. The listing of Ahlstrom's shares could only be made after the expiry of the period during which subscription applications could be submitted.[485] Trading in Ahlstrom shares commenced on the prelist on 14 March 2006 and on the main list on 17 March 2006.

Trade register. This required the filing of the increase in share capital with the trade register.[486]

Over-subscription, use of over-allotment option. In connection with the Ahlstrom IPO, SEB Enskilda exercised, on behalf of the underwriters, the over-allotment option to subscribe for 1,150,000 additional shares of Ahlstrom Corporation to cover over-allotments in the institutional tranche of the offering. The underwriters were paid commissions.[487] Ahlstrom issued the additional shares.

Trade register. The increase in share capital caused by the exercising of the over-allotment option granted to the underwriters in connection with the initial public offering of Ahlstrom was registered by the trade register on 17 March 2006. The share capital was increased by 1,150,000 shares equaling €1,725,000.

Stabilisation. SEB Enskilda, the Lead Manager and Bookrunner in the Ahlstrom IPO, did not carry out any stabilisation measures with Ahlstrom share. The stabilisation period ended on 13 April 2006.

Disclosure of steps. Ahlstrom disclosed all steps in the IPO process. Community law does not require ad-hoc disclosure of information about the IPO process before the publishing of a prospectus. Issuers whose securities have not yet been admitted to trading do not have any ongoing disclosure obligations under EU securities markets laws. However, Community law does not prevent Member

[484] Under the Rules of the Stock Exchange.
[485] Article 47 of Directive 2001/34/EC (Listing Directive).
[486] Article 3 of Directive 77/91/EEC (Second Company Law Directive).
[487] Article 11 of Regulation 2273/2003. See also Articles 8(1) and 8(2) of Directive 77/91/EEC (Second Company Law Directive).

States from requiring such disclosure.[488] After admission to trading, the obligation to disclosure all steps in the IPO process was based on the Directive on market abuse and the Commision Regulation implementing that Directive.

5.10.3 Internal Corporate Action

In the Ahlstrom case, the company took measures in anticipation of the IPO in order to simplify the process of complying with legal requirements during the IPO.

Resolutions in anticipation of the IPO. Before the IPO of Ahlstrom Corporation, the general meeting approved the board's proposal to distribute an extra dividend for the previous financial year.[489] New investors would thus not benefit from accumulated profits.

The articles of association were amended in various ways. As the company had two classes of shares, the general meeting passed a resolution to combine them. The company would thus have only one share class. Increased liquidity of the company's shares and the lack of a share class reserved for controlling shareholders were likely to increase the price that investors were prepared to pay for new shares. The existence of only one share class also simplified voting and majority requirements.[490] A redemption clause was removed, as only freely transferable securities can be admitted to trading on a regulated market.[491] A mandatory bid clause used as a takeover defence (poison pill) was amended (see section 18.4).

In addition, the general meeting approved a change of the terms of the company's stock option programmes.

Resolutions authorising the board to decide on the IPO. After such resolutions, the general meeting could decide on the IPO. The general meeting authorised the board to decide on core questions of the IPO such as increase in share capital, issuing of shares, price payable for new shares, and withdrawal of pre-emption rights. In addition, the general meeting authorised the board to decide on the modalities of the IPO such as the detailed terms of the IPO.

Increase in share capital. At that time, each of the company's shares had a nominal value of €1.50.[492] Because of the shares having a nominal value, new

[488] See, for example, recital 15 of Directive 2003/71/EC (Prospectus Directive): "The disclosure requirements of the present Directive do not prevent a Member State or a competent authority or an exchange through its rule book to impose other particular requirements in the context of admission to trading of securities on a regulated market (notably regarding corporate governance). Such requirements may not directly or indirectly restrict the drawing up, the content and the dissemination of a prospectus approved by a competent authority."

[489] Articles 15(1) and 15(2) of Directive 77/91/EEC (Second Company Law Directive).

[490] Articles 3(e), 25(3), 31 and 38 of Directive 77/91/EEC (Second Company Law Directive).

[491] Article 46 of Directive 2001/34/EC (Listing Directive).

[492] Article 3(b) of Directive 77/91/EEC (Second Company Law Directive).

shares could not be issued without a decision to increase share capital in addition to a decision to issue new shares. EU company law does not require a nominal value. Shares can have an accountable par value instead of a nominal value.[493]

The general meeting approved a resolution to authorise the board to decide on increasing the company's share capital through a new issuance of shares.[494] The resolution laid down a maximum amount but no minimum amount.

Price. The general meeting decided on the price payable for the shares. However, instead of regulating the price in detail, the general meeting stated that the price would be determined on the basis of a bookbuilding method and authorised the board of directors to determine it.[495]

When deciding on the IPO, the board also decided that the initial offer price range was €20.00–24.00 per share. According to the terms of the offer, investors paid €24 per share in connection with subscription commitments. After the allotment of shares and the fixing of the price payable for shares, excess payments were to be returned to investors according to the terms of the offer.

Withdrawal of pre-emption rights. As the shares were to be offered to domestic and international institutional investors and the public in Finland, it was necessary to withdraw existing shareholders' pre-emption rights.[496] The board was authorised to decide on this issue as well.

As required by the governing law, the board of directors presented to the general meeting a written report indicating the reasons for withdrawal and justifying the proposed issue price.[497] According to the board, the company would, by means of the new issue, expand the number of its shareholders with new investors, create new sources of financing, facilitate the use of shares as consideration in connection with acquisitions, and improve the possibilities of utilising share-based incentive systems for the company's personnel. As regards the price, the use of the bookbuilding method was said to ensure that the price payable for the shares would be their market value.

Conditions. Some resolutions were subject to particular conditions. The general meeting prohibited the filing of the resolutions on the increase in share capital and amendment of articles of association with the trade register before the signing of an Underwriting Agreement or after a certain date.

Board decisions in anticipation of the IPO. Like the general meeting, the board of directors took many decisions in anticipation of the IPO. First, all resolutions of the general meeting taken in anticipation of the IPO were based on proposals submitted by the board. Second, the resolutions authorising the board to decide on matters relating to the IPO were also based on proposals submitted by the board.

Board decisions on the IPO. The board of directors decided on the IPO after being empowered to do so by the general meeting.

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[493] Articles 3 and 8(1) of Directive 77/91/EEC (Second Company Law Directive).
[494] Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).
[495] Article 25(2) of Directive 77/91/EEC (Second Company Law Directive).
[496] Article 29(4) of Directive 77/91/EEC (Second Company Law Directive).
[497] Article 29(4) of Directive 77/91/EEC (Second Company Law Directive).

First, the board of directors decided: to arrange an offering of up to 8,000,000 new shares in Ahlstrom Corporation to Finnish and international institutional investors (the institutional offering), and to retail investors in Finland (the retail offering); to withdraw existing shareholders pre-emption rights; that the initial offer price range was €20.00–24.00 per share; that the board would make the final decision on the number of shares to be offered for subscription and the offer price after the marketing period in the Institutional Offering had ended; on the detailed terms of the IPO; that Ahlstrom would apply for the shares to be listed on the main list of the Helsinki Stock Exchange; to grant SEB Enskilda, acting on behalf of the managers, an over-allotment option; and to authorise SEB Enskilda to take stabilisation measures.

Second, the board of directors of Ahlstrom Corporation decided: that Ahlstrom would issue a total of 8,000,000 of its shares in its IPO; that both the institutional offering and the retail offering would be priced at €22.00 per share; that 6,600,000 shares would be allocated to institutional investors and 1,400,000 shares to retail investors; and on the allocation of shares allotted by the company between subscribers.

The allocation of shares created some problems, because the IPO was heavily oversubscribed. A holding company owned by the controlling family was granted the right to maintain its proportional shareholding in the company, assuming that SEB Enskilda exercised the over-allotment option in full. In the retail offering, subscription commitments were fully accepted up to 50 shares. For commitments exceeding 50 shares, investors in the retail offering were additionally allocated approximately 18% of the amount exceeding 50 shares. Allocations exceeding 50 shares were rounded to the nearest round lot. Excess payments made in connection with the subscription commitments were returned to investors.

Third, the board decided to file the increase in share capital with the trade register.[498]

Fourth, after SEB Enskilda exercised the over-allotment option to subscribe for 1,150,000 additional shares of Ahlstrom Corporation to cover over-allotments in the institutional tranche of the offering, the board of directors decided to allot those shares.

Fifth, the board again decided to file the increase in share capital with the trade register.

5.11 Shares as a Means of Payment

5.11.1 Introduction

Companies can have many reasons for not turning to existing shareholders for fresh capital. For example, a rights issue tends to reduce a listed company's share

[498] Article 3 of Directive 68/151/EEC (First Company Law Directive) and Article 3 of Directive 77/91/EEC (Second Company Law Directive).

price. However, shares can also be used as a *means of payment*, i.e. allotted only to particular investors who are willing to exchange assets for shares. Such situations range from mergers and share exchanges to the use of share-based executive incentive programmes.

5.11.2 Community Law: General Remarks

Shares are a means of payment, if shares are subscribed for against consideration other than in cash or at an undervalue. Due to the European legal capital regime, the use of shares as a means of payment is generally constrained by mandatory company law provisions vesting veto rights in the general meeting. There are five core constraints.

First, the use of shares as a means of payment is not possible without a resolution by the *general meeting*. There is usually a connection between the number of shares and the amount of legal capital. According to the Second Company Law Directive, the general meeting decides on any increase in the subscribed capital[499] or the authorisation of a company body to decide on an increase in the subscribed capital.[500] If the number of shares is set out in the articles of association, the use of shares as a means of payment can require the amendment of the articles of association.[501]

Second, existing shareholders have *pre-emption* rights.[502] The Second Directive provides that the general meeting decides on the withdrawal of shareholders' right of pre-emption[503] or the authorisation of a company body to decide on it.[504]

Third, shares may not be issued at an *undervalue*. (a) The main rule is that shares may not be issued at a price lower than their nominal value, or, where there is no nominal value, their accountable par.[505] (b) Member States may nevertheless allow those who undertake to place shares in the exercise of their profession to pay less than the total price of the shares for which they subscribe in the course of the transaction.[506] (c) If the company issues shares for a consideration other than in cash and the subscribed capital is increased, that consideration must consist of assets capable of economic assessment. An undertaking to perform work or supply services may not form part of those assets.[507]

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[499] Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).

[500] Article 25(2) of Directive 77/91/EEC (Second Company Law Directive).

[501] Article 3 of Directive 77/91/EEC (Second Company Law Directive).

[502] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive): "Whenever the capital is increased by consideration in cash, the shares must be offered on a pre-emptive basis to shareholders in proportion to the capital represented by their shares."

[503] Article 29(4) of Directive 77/91/EEC (Second Company Law Directive).

[504] Article 29(5) of Directive 77/91/EEC (Second Company Law Directive).

[505] Article 8(1) of Directive 77/91/EEC (Second Company Law Directive).

[506] Article 8(2) of Directive 77/91/EEC (Second Company Law Directive).

[507] Article 7 of Directive 77/91/EEC (Second Company Law Directive).

Fourth, the Second Directive lays down minimum requirements as to when the shares must be *paid up*.[508]

Fifth, before the company issues shares for a consideration other than in cash, a report must usually[509] be drawn up by one or more *independent experts* appointed or approved by an administrative or judicial authority.[510] The Second Directive provides that the experts' report "shall contain at least a description of each of the assets comprising the consideration as well as of the methods of valuation used and shall state whether the values arrived at by the application of these methods correspond at least to the number and nominal value or, where there is no nominal value, to the accountable par and, where appropriate, to the premium on the shares to be issued for them".[511] The expert's report must be made public.[512]

There are three main *exceptions* to this requirement. First, Member States may decide not to require a report "in the event of an increase in subscribed capital made in order to give effect to a merger or a public offer for the purchase or exchange of shares and to pay the shareholders of the company which is being absorbed or which is the object of the public offer for the purchase or exchange of shares".[513] In those cases, similar information will be disclosed under the Directive on takeover bids[514] or the Merger Directive[515] or both. Second, Member States may decide not to require the report where the consideration consists of transferable securities admitted to trading on a regulated market.[516] In this case, there is market price. Third, Member States may decide not to require a report in some cases where all the shareholders (for example, the sole shareholder) in the company that receives the consideration have agreed not to have an experts' report drawn up.[517]

The five core constraints will influence all transactions where the company uses its shares as a means of payment. There are also case-specific constraints depending on the nature of the transaction.

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[508] See Articles 26 and 27(1) of Directive 77/91/EEC (Second Company Law Directive).
[509] See Articles 10(4), 27(3) and 27(4) of Directive 77/91/EEC (Second Company Law Directive).
[510] Articles 10(1) and 27(2) of Directive 77/91/EEC (Second Company Law Directive).
[511] Article 10(2) of Directive 77/91/EEC (Second Company Law Directive).
[512] Article 10(3) of Directive 77/91/EEC (Second Company Law Directive).
[513] Article 27(3) of Directive 77/91/EEC (Second Company Law Directive).
[514] Article 6 of Directive 2004/25/EC (Directive on takeover bids).
[515] Articles 9 and 10 of Directive 78/855/EEC (Third Company Law Directive).
[516] Articles 10a and 10b of Directive 77/91/EEC (Second Company Law Directive).
[517] Article 27(4) of Directive 77/91/EEC (Second Company Law Directive).

5.11.3 Mergers and Share Exchanges

General Remarks

In an acquisition, the company can turn to the target's shareholders instead of its own shareholders. Mergers and share exchanges are important ways to finance takeovers. Share exchanges are often used in public takeover bids.

Terminology. The terms "merger", "acquisition" and "takeover" tend to be used interchangeably in business practice. For example, the "EC Merger Regulation" is the basis of European "merger control".[518]

In EU company law, however, the term "merger" means a procedure whereby two or more separate legal entities combine to form a single entity.[519] In company law, this term does not mean the acquisition of a company through the purchase of its shares or assets. Company law provisions on mergers tend to be complemented by provisions on squeeze-out rights and sell-out rights.

Domestic v cross-border mergers. Mergers can be domestic or cross-border. In a domestic merger, both legal entities are incorporated in the same country and governed by the laws of the same country. A domestic merger is legally less complicated than a cross-border merger.

In a cross-border merger, the participating legal entities are incorporated in different countries and governed by the laws of different countries. A cross-border merger cannot be executed exactly in the same way as a domestic merger, unless there is uniformity of law across borders. Apart from countries like Spain and Portugal, Member States' traditional company law rules used to prohibit cross-border mergers in order to protect creditors and shareholders. Company laws used to address only the domestic side of a merger.

Mergers v takeover bids. There is a distinction between a merger offer and a takeover bid. A takeover bid can consist of an offer to buy shares for cash, an offer to allot shares in exchange for shares in the target company, or a merger offer. If successful and the offeror's holdings trigger squeeze-out rights, a takeover bid will often be followed by a short-form merger. The use of a triangular structure (section 11.2) typically leads to the merger of the acquisition vehicle and the target company.

An all-cash takeover bid (tender offer) can be faster in comparison to the one-step merger or a share exchange offer. On the other hand, target shareholders have no obligation to accept the offer.[520]

Mergers v share exchanges. There is also a distinction between mergers and share exchanges. A share exchange means that the acquirer issues shares in exchange for shares in the target company. If a sufficient number of shares are exchanged, the target will become a subsidiary of the acquirer. A share exchange

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[518] Regulation 139/2004 (EC Merger Regulation).

[519] See Articles 3 and 4 of Directive 78/855/EEC (Third Company Law Directive) and Article 2 of Directive 2005/56/EC (Directive on cross-border mergers).

[520] See Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice. New York City (2008) pp 129–130.

does not mean the merger of those companies. In practice, however, a share exchange is sometimes followed by a merger.

In a merger, two or more companies combine to form a single legal entity. After the merger, only one legal entity will survive. The shares of companies that will not survive the merger are converted into shares of the legal entity that will survive or whatever consideration was specified in the terms of the merger.

There can be differences between mergers under Community law and US laws. This can be illustrated by the 2008 "merger" of Bear Stearns Companies Inc. with JP Morgan Chase & Co. Both companies were listed companies incorporated under the laws of Delaware. Their boards agreed to merge the two companies. The merger was approved by the majority of votes at the stockholders' meeting of Bear Stearns. Upon completion of the merger, the shares of Bear Stearns were converted into shares of JP Morgan Chase. Bear Stearns thus became its wholly-owned subsidiary. The stockholders of JP Morgan Chase did not vote on the transaction. According to Community law, the transaction would have been a share exchange rather than a merger. The shareholders of Bear Stears could not have been forced to sell unless a majority shareholder had a squeeze-out right. The shareholders of JP Morgan Chase would have had a right to decide on the issuing of new shares and the waiving of their pre-emptive rights.

Mergers v acquisitions of substantially all corporate assets. There is also a distinction between mergers on one hand and acquisitions of all or substantially all corporate assets on the other.

In the latter case, the seller will survive the transaction and any remuneration will be paid to the seller rather than its shareholders. The sale of all or substantially all corporate assets is therefore not governed by the same provisions as "real" mergers.

However, the sale of all or substantially all corporate assets can have a negative impact on the position of the seller's shareholders and creditors. For this reason, such transactions may be constrained by special provisions of company or securities markets laws. For example, some countries' laws provide that such transactions are decided on by the seller's shareholders.

In *Germany*, shareholders vote on "fundamental matters" (Grundlagenentscheidungen) according to the principle in the *Holzmüller* case.[521] In *England*, the Listing Rules provide that shareholder approval must be obtained for decisions which are likely to have a major impact on the company's business.[522]

Mergers of other legal entities. Mergers are not limited to limited-liability companies. Even other legal entities can merge. The rules that govern mergers depend on the business form of the constituent entities. For example, the vote necessary to accomplish a merger will vary depending on their business form. For limited-liability companies, a qualified majority vote will suffice. For partnerships and limited partnerships, the default rule is that a merger requires an unanimous decision by the partners.

[521] BGHZ 83, 122.
[522] LR 10.2.2 R and 10.5.1 R.

Choice between a merger and a share exchange. In the EU, share exchanges and mergers raise similar fundamental legal questions. In both cases, the European legal capital regime with its corporate governance rules means that the transaction may have to be decided on by shareholders. It may be necessary to apply legal rules on voluntary bids, mandatory bids, squeeze-out rights, and sell-out rights. The companies will have to comply with various disclosure obligations. There are also legal constraints on pricing.

There are nevertheless many differences. (a) As a rule, mergers are always *friendly*. A merger requires a merger plan (draft terms of merger), that is, an agreement between the boards of the participating companies.[523] A share exchange offer can be friendly or unfriendly, because it does not necessarily require co-operation by the target's board. If the target's board does not recommend the exchange offer to shareholders, the bidder can make a hostile offer. (b) A merger usually requires the consent of the *general meeting* of the target and the general meeting of the surviving company.[524] In a share exchange, however, shareholders of the target accept the offer by selling their shares or refuse the offer by holding on to their shares. A share exchange is therefore less complicated and faster than a merger. (c) A merger usually requires a qualified majority at the general meeting of the target.[525] On the other hand, if that majority has been reached, the surviving company will obtain full control of the company that will not survive the merger. In a share exchange, the buyer must take *minority* rights into account (for block-ownership, see Volume I). The buyer typically needs a large block of shares before it can obtain full control of the target. Obtaining full control may require the use of squeeze-out rights.[526] (d) In a merger, even *dissenting shareholders* can be forced to part with their shares under Member States' national laws. For this reason, company laws tend to provide for dissenter rights. Dissenting shareholders may be entitled to an appraisal remedy. In a share exchange, dissenting shareholders cannot always be forced to sell. For this reason, they do not benefit from dissenter rights. However, minority shareholders may be forced to sell, if the acquirer's share of votes or capital exceeds a threshold which triggers a squeeze-out right. In that case, they will be protected through roughly similar rules as dissenters in a merger.

Mergers v reverse takeovers. A reverse takeover is legally a takeover in which a company purchases shares in another company and pays for the acquisition with its own shares. From a legal perspective, the company that takes over the other company is the company that issues new shares to the owners of the target company. From a *business perspective*, the takeover is a reverse takeover, if the tar-

[523] Article 5(1) of Directive 78/855/EEC (Third Company Law Directive).
[524] Article 7(1) of Directive 78/855/EEC (Third Company Law Directive).
[525] Article 7(1) of Directive 78/855/EEC (Third Company Law Directive).
[526] For example, Article 15 and recital 24 of Directive 2004/25/EC (Directive on takeover bids).

get's shareholders or the target's business organisation will *control the buyer* after the takeover.[527]

For legal reasons, reverse takeovers are always *friendly*. A reverse takeover requires issuing new shares and the waiving of existing shareholders' pre-emptive rights. It can be achieved with or without a formal merger.

Privately-owned companies sometimes use a reverse takeover as a way to avoid *admission requirements*. This will work only provided that the reverse takeover will not lead to the cancellation of the listing under the governing law.

According to the MiFID, the operator of the stock exchange (regulated market) may *suspend or remove* from trading a financial instrument which no longer complies with its rules of the regulated market unless such a step would be likely to cause significant damage to the investors' interests or the orderly functioning of the market.[528] Member States' competent authoritites may require the suspension of trading in a financial instrument or require the removal of a financial instrument from trading.[529] For example in England, the FSA will generally cancel the listing of a listed company's securities when it completes a reverse takeover.[530]

Reverse takeovers can be illustrated by the reverse takeover of the logistics business of John Nurminen Oy, a Finnish company. In 2007, John Nurminen Oy was a large privately-owned limited-liability company. Kasola Oyj was a small but listed company that manufactured safes. The controlling shareholders of John Nurminen and Kasola agreed that: all current business activities of Kasola would be sold to its controlling shareholders; Kasola would buy the logistics business activities of John Nurminen; Kasola would pay for the logistics business by issuing new shares to John Nurminen; John Nurminen would become the new controlling shareholder of Kasola; and the name of Kasola Oyj would be changed to Nurminen Logistics Oyj. In other words, the logistics business of (the old) John Nurminen Oy was listed without (the old) John Nurminen Oy having to comply with any admission requirements. This case raised several questions of corporate governance, the protection of the interests of minority shareholders, expropriation of assets by controlling shareholders, and the dilution of minority shareholders' holdings.

Company law and securities markets law. If one of the parties is a company whose shares have been admitted to trading on a regulated market (a listed company), the parties must comply with securities markets laws.

As regards EU securities markets law, merger offers and share exchange offers (tender offers) are basically governed by the same rules addressing both the offering of securities to the public in general and takeovers of listed companies in particular.

Rules implementing legal instruments adopted by Community institutions are complemented by national laws and stock exchange rules. For example, the City

[527] In England, a reverse takeover has been defined in the City Code on Takeovers and Mergers: "A transaction will be a reverse takeover if an offeror might as a result need to increase its existing issued voting equity share capital by more than 100%." Notes on Rule 3.2 of the City Code.

[528] Article 41(1) of Directive 2004/39/EC (MiFID).

[529] Article 50(2)(j) and (k) of Directive 2004/39/EC (MiFID).

[530] LR 5.2.3 G.

Code on Takeovers and Mergers is concerned with regulating takeover bids, however effected, and both mergers and tender offers fall within its scope.

Because of the strict rules of the Takeover Code, cash offers tend to more feasible than tender offers and statutory mergers in UK takeover practice.

Particular Legal Risks

As mergers and share exchange offers mean that two or more businesses will be combined, they give rise to particular legal risks: it would be difficult to undo a takeover; the risk of time-consuming litigation can frustrate an acquisition; and the valuation of securities influences the risk of litigation.

Undoing of takeovers. Company laws generally discourage the undoing of mergers, and they discourage litigation that can frustrate mergers. Shareholders in a company that will not survive the merger tend to have only very limited rights to contest a merger in the court ex post.[531] Instead, they are protected by appraisal rights and a right to obtain a fair price for their shares.[532]

Share exchanges are not governed by the same rules. They are nevertheless governed by company law rules on the issuing of shares for a consideration other than in cash. There are sanctions for the breach of such rules. Depending on the governing law, the breach of legal constraints based on Community law may increase the risk that the resolutions on which the issuing of shares was based are declared invalid.[533] This is because penalties in respect of infringements of Community law must be effective, proportionate and dissuasive.[534]

Litigation. A merger can lead to litigation in both participating companies. In contrast, a share exchange offer is less likely to lead to litigation in the target company as the offer requires less corporate action by the target. A public takeover bid is an example of a transaction where the board of the target must take some corporate action. Squeeze-out procedures following the bid or otherwise are likely to lead to litigation in some countries.

In Germany, practically all squeeze-out processes are contested in the court. There is a class of professional litigants that bring proceedings in bad faith (Berufskläger).[535]

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[531] Recital 9 and Article 22 of Directive 78/855/EEC (Third Company Law Directive); Recital 8 and Article 17 of Directive 2005/56/EC (Directive on cross-border mergers); Article 30 of Regulation 2157/2001 (SE Regulation).

[532] Article 28 of Directive 78/855/EEC (Third Company Law Directive).

[533] See, for example, Articles 9(1) and 9(2) of Directive 68/151/EEC (First Company Law Directive).

[534] Case 68/88 Commission v Greece [1989] ECR 2965, paragraphs 23 and 24; Case C-326/88 Hansen [1990] ECR I-2911, paragraph 17; Case C-36/94 Siesse [1995] ECR I-3573, paragraph 20; Case C-177/95 Ebony Maritime and Loten Navigation [1997] ECR I-1111, paragraph 35; Case C-167/01 Inspire Art [2003] ECR I-10155, paragraph 63.

[535] Jahn J, Meist enden Aktionärsausschlüsse vor Gericht, FAZ, 23 Oktober 2007.

Valuation. Valuation questions are a source of legal risk due to the openness of valuation rules. Valuation questions can therefore give rise to litigation. They can also give rise to other kinds of legal risks.

This can be illustrated by the US case of AOL Time Warner. A share exchange or a formal merger can enable a shareholder to benefit from differences in the market valuation or different firms. During the dot-com bubble, the unrealistically high valuation of Internet firms enabled them to merge with traditional firms on terms that benefited their shareholders; in some cases, a large share block in a nearly insolvent company became a large share block in a financially sound company. A classic example is the merger of Time Warner and America Online in 2000. A new company called AOL Time Warner was created. The smaller AOL had, in fact, bought out the far larger Time Warner. Because market conditions at the time of the merger valued Internet-related shares much higher than traditional media shares, the shareholders of AOL ended up owning 55% of the new company while Time Warner shareholders owned only 45%. It turned out that this was favourable for AOL shareholders but quite the opposite for Time Warner shareholders, because the profitability and market valuation of internet companies fell soon after the merger. This forced a goodwill write down, causing AOL Time Warner to report a loss of $99 billion in 2002. At the time, this was the largest loss ever reported by a company. In response to the huge loss in 2002, the company dropped the "AOL" from its name (see Wikipedia).

5.11.4 Mergers and Company Law

General Remarks

Although all legal entities can merge, the commercially most important merger form is that of two limited-liability companies combining to form a single entity. There are three basic merger forms: One or more companies can merge with one existing company that survives the merger (merger by acquisition).[536] Alternatively, two or more companies can merge and form a new company that survives the merger (merger by the formation of a new company).[537] The third basic merger form is the merger of a wholly-owned or almost wholly-owned subsidiary with its parent company. It is a particular merger form, because it is subject to simplified formalities.[538]

Consequences of a merger. A merger has several consequences.[539] In the EU, the most important consequences are as follows:[540] (1) The company designated as the surviving entity continues its existence. (2) The separate existence of the company or companies that are merged into the surviving entity ceases. (3) All the as-

[536] Article 3 of the Directive 78/855/EEC (Third Company Law Directive).

[537] Article 4 of Directive 78/855/EEC (Third Company Law Directive).

[538] Article 24 of Directive 78/855/EEC (Third Company Law Directive); Article 15 of Directive 2005/56/EC (Directive on cross-border mergers).

[539] See Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 155–156, referring to MCBA § 11.07.

[540] Article 19 of Directive 78/855/EEC (Third Company Law Directive); Article 14 of Directive 2005/56/EC (Directive on cross-border mergers); Article 29 of Regulation 2157/2001 (SE Regulation).

sets and liabilities of the companies that do not survive the merger are transferred to the surviving entity. (4) The shares of each non-surviving company are converted into whatever consideration was specified in the merger agreement and the former shareholders of the non-surviving companies are entitled only to the rights provided them in the merger agreement or by the governing law.

Company law reasons to merge. There are various company law reasons for companies to merge. (1) Mergers enable the firm to acquire large companies without compromising its debt-to-equity ratio. Shareholders of the company that will not survive the merger are entitled to a consideration for their shares, usually shares in the surviving company. A merger thus enables the firm to pay for a company through allotment of its own shares. (2) Alternatively, a merger enables highly leveraged LBOs. The firm can raise debt and pay for the target's shares in cash. After the completion of the takeover, those two firms can merge. This means that the debts will in effect be repaid from the assets of the target. (3) There are control aspects. Although the main rule is that shareholders of the company that will not survive the merger will receive shares in the surviving company, the consideration can, depending on the governing law, also consist of cash or other securities or a combination of shares, cash and other securities. A merger will thus enable the firm to manage its share ownership structure. (4) Some reasons relate to the legal structure of the firm. A merger of two companies after a takeover means that there will be one surviving company rather than a parent with a subsidiary. This can simplify the legal structure of the firm, and reduce legal costs. For example, cross-border mergers are a means to avoid a layer of national holding companies. (5) Cross-border mergers also enable the firm to change the place where it is incorporated and the law governing the company (Volume I).

EU merger law: general remarks. There are many sources of EU merger law. To begin with, mergers are covered by the freedom of establishment guaranteed by the EC Treaty. However, there is only piece-meal regulation of mergers at Community level.

Questions of company law. Questions of company law have been addressed by several Community instruments. (a) Domestic mergers of public limited-liability companies (such as the AG or SA) are governed by the Third Company Law Directive.[541] The Third Company Law Directive does not apply to private limited-liability companies. (b) Cross-border mergers of limited-liability companies are governed by the Directive on cross-border mergers.[542] That Directive applies to all companies governed by the First Company Law Directive (all limited-liability companies) and not just to companies governed by the Second Company Law Directive (public limited-liability companies). The judgment of the ECJ in *Sevic Systems* in effect forced Member States to permit cross-border mergers.[543] (c) Some cross-border mergers are governed by the SE Regulation[544] or the SCE Regula-

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[541] Directive 78/855/EEC (Third Company Law Directive).

[542] Directive 2005/56/EC (Directive on cross-border mergers).

[543] Case C-411/03 Sevic Systems [2005] ECR I-10805, paragraph 23.

[544] Regulation 2157/2001 (SE Regulation).

tion,[545] as an SE can be formed by private or public limited-liability companies by means of a cross-border merger (Articles 2(1), 17, and 32) and an SCE can be formed through a cross-border merger of existing cooperative sociaties. (d) Public takeover bids as well as squeeze-out rights and sell-out rights following public takeover bids are governed by the Directive on takeover bids.[546]

The purpose of the regulation of mergers is: to protect the interests of shareholders; to keep shareholders adequately informed in as objective a manner as possible; to protect the interests of creditors and persons having other claims on the merging companies so that the merger does not adversely affect their interests; and to keep third parties adequately informed.[547]

Other questions. In the EU, the regulation of the company law aspects of mergers is complemented by legal instruments that protect the interests of employees, EU capital markets law, EU merger control, and EU tax law.

EU company law requires the participating companies to disclose how the merger will affect the position of employees.[548] The protection of employees' rights in the event of mergers is regulated by many labour law Directives;[549] for example, they are protected in the event of transfers of undertakings by Directive 2001/23/EC the purpose of which is to ensure the continuity of employment relationships.[550] Directive 2001/86/EC is designed to ensure that employees have a right of involvement in issues and decisions affecting the life of their SE.[551] Employee issues will be discussed in section 12.6 in more detail.

One of the purposes of EU securities markets law is to protect shareholders – especially minority shareholders – in the context of takeover bids.[552]

EU merger control is based on the competition law provisions of the EC Treaty (Articles 81 and 82) and the EC Merger Regulation. The EC Merger Regulation applies to the control of concentrations[553] between undertakings.

Mergers have been regulated even by the provisions of EU tax law directives. According to Directive 90/434/EEC,[554] a merger or division shall not give rise to

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545 Regulation 1435/2003 (SCE Regulation).

546 Article 5(1) of Directive 2004/25/EC.

547 Recitals of Directive 78/855/EEC (Third Company Law Directive). See also recitals 2 and 9 of Directive 2004/25/EC (Directive on takeover bids).

548 Articles 5(d), 5(j), and 7 of Directive 2005/56/EC (Directive on cross-border mergers); Articles 20(1) and 32(2) of the SE Regulation.

549 Recital 12 of Directive 2005/56/EC (Directive on cross-border mergers) refers to Directive 98/59/EC (collective redundancies), Directive 2001/23/EC (transfers of undertakings), Directive 2002/14/EC (framework for informing and consulting employees), and Directive 94/45/EC (European Works Council, procedure for informing and consulting employees). See also Article 12 of Directive 78/855/EEC (Third Company Law Directive).

550 Article 1 of Directive 2001/23/EC. Case C-458/05 Jouini et al [2007] ECR I-7301, paragraphs 23–25 and 31–32.

551 Recital 21 of Regulation 2157/2001 (SE Regulation).

552 Recitals 2 and 9 of Directive 2004/25/EC (Directive on takeover bids).

553 Article 3(1) of Regulation 139/2004 (EC Merger Regulation).

any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes.[555] Where the receiving company has a holding in the capital of the transferring company, any gains accruing to the receiving company on the cancellation of its holding shall not be liable to any taxation.[556]

Merger Process

If the participating companies are limited-liability companies incorporated in the EU, the merger process is to a large extent based on the provisions of those Community instruments. Like all business acquisitions, it will also be influenced by commercial practice.

Competent authorities. In a purely domestic merger, the competent authorities are determined by that Member States' national law. In a cross-border merger, more than one Member States' authorities may have jurisdiction: authorities in the country whose laws govern the entity that will not survive the merger; authorities in the country whose laws govern the entity that will survive the merger; and authorities in the country whose laws govern the entity that is formed by merger.

Commencement of negotiations, management of information. Mergers are friendly. The commencement of negotiations will be complemented by the conclusion of agreements that protect confidentiality on one hand and reduce the risk inherent in investment in the production of information on the other.

The parties will therefore conclude non-disclosure agreements. If one of the parties is a listed company, project-specific insider lists must be prepared (section 12.2). The parties may also undertake obligations to negotiate in good faith and various kinds of exclusivity obligations (section 12.4).

If that contractual framework is in place and the parties still want the transaction, the parties will move to the next level in the legal framework.

Moral obligations, due diligence. The next step is to ensure that the legal framework makes it possible to disclose more confidential information to the other party. For example, the parties may sign a letter of intent. The letter of intent will set forth the proposed structure of the deal. According to its wording, it will not create any obligation to conclude the transaction. However, it will create a moral obligation. It provides a framework and context for further negotiations and due diligence (see section 12.3, Chapter 13, and Volume II).[557]

Draft terms of merger (merger plan). If the parties want to go on with the transaction, the parties must draw up the common draft terms of merger (a merger

[554] Directive 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States.

[555] Article 4(1) of Directive 90/434/EEC.

[556] Article 7(1) Directive 90/434/EEC. Article 7(2) provides: "The Member States may derogate from paragraph 1 where the receiving company's holding in the capital of the transferring company does not exceed 25%."

[557] See Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) p 174.

plan). The draft terms will be approved by the boards of the participating companies.[558] As the merger requires the consent of the general meeting, the draft terms can be described as a conditional contract that will become binding provided that the merger is approved by the general meeting. The draft terms will contain much of the information that must be disclosed to sharereholders.

Filing of basic information about the merger. For each of the merging companies, basic information about the proposed merger must be filed with the companies register and published in the national gazette.[559]

Obligations to take corporate action v material adverse change. After the approval of the merger plan, the outcome of the merger process will be in the hands of the shareholders. There is thus a risk that the other party fails to take the necessary corporate action. The board of a participating company can mitigate that risk by means of exclusivity clauses and clauses on liquidated damages. The parties may also agree on a break-up fee.

As it can take months to finalise the merger, the parties often mitigate the risk of changing circumstances through the inclusion of a material adverse change clause. That clause can be complemented by a break-up fee clause (section 12.4.2).

If the distribution of power between different corporate bodies is, as in continental Europe, governed by mandatory provisions of company law, the board is more likely to be prohibited from frustrating the general meeting's (or the supervisory board's, as the case may be) right to decide on the merger. There are therefore constraints on the use of liquidated damages and break-up fees. For example, the duty to pay a large break-up fee or a large amount as liquidated damages in the event that the general meeting votes against the merger would, in practice, make it more difficult for shareholders to decide on the merger on its merits.

On the other hand, it is in the interests of both parties to agree that failure to take the necessary corporate action will trigger some sanctions. Without such sanctions, it would be riskier to disclose information to the other party and to commence the merger process. Even if the parties had agreed on non-disclosure agreements, information disclosed by a party in the course of the merger process would be likely to benefit the other party should the merger fail. In addition, both parties will incur costs in the course of the merger process. It would be unwise for a participating company not to ensure that it will be reimbursed for the harm caused by the disclosure of information to the other party and the costs that it has incurred.

Disclosure of information to shareholders. Shareholders need plenty of information in order to be able to decide on the merger. The questions that interest shareholders the most are the legal validity of the transaction and compliance with

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[558] Article 3 of Directive 78/855/EEC (Third Company Law Directive); Article 5 of Directive 2005/56/EC (Directive on cross-border mergers); Article 20 of Regulation 2157/2001 (SE Regulation).

[559] Article 6 of Directive 78/855/EEC (Third Company Law Directive). See also Article 6 of Directive 2005/56/EC (Directive on cross-border mergers); Article 21 of Regulation 2157/2001 (SE Regulation); Article 24 of Regulation 1435/2003 (SCE Regulation).

the rules that protect shareholders, the valuation of the participating companies' shares, the share exchange ratio, and the amount of any cash payment. In addition, shareholders will consider what will happen if they dissent.

Much of that information is contained in the draft terms of the merger (merger plan). Draft terms of merger must be published at least the minimum of one month before the date fixed for the general meeting which is to decide on the merger.[560]

The merger also requires the submission of proposals and opinions (see below) to the general meeting, and a listed company must comply with the information regime for listed companies (section 5.9).

Information intermediaries. Although that information is disclosed to shareholders, it may be difficult for a shareholder to understand the transaction. For example, mergers can raise difficult legal questions and difficult questions of valuation. Whereas insiders and controlling shareholders know more about the expected general and private benefits of the proposed transaction, non-controlling minority shareholders and employees must rely on information intermediaries (for information intermediaries, see Volume I).

The most important information intermediary is the board. The board will be responsible for the draft terms of the merger and the proposals submitted to the general meeting. In addition, the board must submit a report. For example, the Third Company Law Directive provides: "The administration or management bodies of each of the merging companies shall draw up a detailed written report explaining the draft terms of merger and setting out the legal and economic grounds for them, in particular the share exchange ratio. The report shall also describe any special valuation difficulties which have arisen."[561]

The merger plan will be reviewed by independent experts, another class of information intermediaries. They will submit a report to the general meeting.[562]

In addition, the board will usually obtain a fairness opinion from an investment bank and submit it to the general meeting. The stated purpose of fairness opinions is often to ensure that the merger consideration is fair to shareholders from a financial point of view. In addition, their purpose is to: make the proposed transaction look good; signal to shareholders that they should vote for the merger; and to mitigate the risk of board members' liability for breach of duty. The board may also submit other opinions by independent advisers. The submission of a fairness opinion or the substance of other independent advice can be mandatory under the applicable securities markets laws. Even when it is not mandatory, it may be part of commercial practice (for fairness opinions and independent advice, see also sections 13.4, 17.3 and 19.9).

Depending on the transaction and the governing law, the legality of the merger can be scrutinised by the competent authority. This is mandatory when an SE is

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[560] Article 6 of Directive 78/855/EEC (Third Company Law Directive).

[561] Article 9 of Directive 78/855/EEC (Third Company Law Directive). See also Article 7 of Directive 2005/56/EC (Directive on cross-border mergers); Article 18 of Regulation 2157/2001 (SE Regulation).

[562] Article 10 of Directive 78/855/EEC (Third Company Law Directive); Article 8 of Directive 2005/56/EC (Directive on cross-border mergers); Article 22 of Regulation 2157/2001 (SE Regulation).

formed by means of a merger,[563] and in cross-border mergers.[564] For example, the Directive on cross-border mergers requires a pre-merger certificate "conclusively attesting to the proper completion of the pre-merger acts and formalities"[565] and scrutiny of the legality of the cross-border merger as regards that part of the procedure which concerns the completion of the cross-border merger.[566]

The usefulness of information provided by such intermediaries can depend on their personal incentives. For example, members of the board will owe duties (such as fiduciary duties or a duty of care) to the company and sometimes even to its shareholders. However, the board is likely to support a merger plan that it has just approved, the board will not employ an investment bank to give a fairness opinion unless the opinion will be favourable, and it can be difficult for shareholders to sue board members for breach of duty.

Whether the information is useful can therefore depend on the quality of regulation.

General meeting. Unless the merger is the merger of a wholly-owned or almost wholly-owned company with its parent company,[567] the merger will be decided on by the general meeting. Shareholders will thus have a veto right. The vote necessary to accomplish a merger will vary depending on the business form of the company, the governing law, and the company's statutes (articles of association).[568]

Company laws provide for a majority vote. The articles of association can require a larger majority (a qualified majority). Where there is more than one class of shares, the decision concerning a merger shall be subject to a separate vote by at least each class of shareholders whose rights are affected by the transaction.[569]

The merger can often require decisions on the amendment of articles of association, the issuing of shares, the increase of share capital, and the removal and appointment of board members.[570] The decision must cover at least the approval of the draft terms of merger and any alterations to the articles of association necessitated by the merger.[571] Those decisions can require a qualified majority.

Remedies of dissenting shareholders. If the merger is approved by the required majority, the merger process will continue. As a rule, dissenting shareholders who lose the vote cannot prevent the merger. However, depending on the governing law, dissenting shareholders may have access to various kinds of remedies.

Shareholders could, in principle, have a right to contest the resolution. The existence of such rights would increase the exposure of the participating companies to legal risk, because – as was the case in Germany – there could be a high tempta-

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[563] Articles 25–26 of the SE Regulation.
[564] Recital 7 of Directive 2005/56/EC (Directive on cross-border mergers).
[565] Article 10(2) of Directive 2005/56/EC (Directive on cross-border mergers).
[566] Article 11(1) of Directive 2005/56/EC (Directive on cross-border mergers).
[567] Articles 8 and 24–28 of Directive 78/855/EEC (Third Company Law Directive).
[568] Articles 7 and 23(3) of Directive 78/855/EEC (Third Company Law Directive); Article 9 of Directive 2005/56/EC (Directive on cross-border mergers); Article 23 of Regulation 2157/2001 (SE Regulation).
[569] Article 7(3) of Directive 78/855/EEC (Third Company Law Directive).
[570] Article 7(3) of Directive 78/855/EEC (Third Company Law Directive).
[571] Article 7(3) of Directive 78/855/EEC (Third Company Law Directive).

tion for minority shareholders to abuse their rights. Time-consuming litigation could frustrate a merger that has already been approved by the general meeting. It is therefore normal to restrict the right of dissenting shareholders to contest the merger resolution. Provisions of EU merger law limit situations in which the merger can be declared null and void.[572]

In principle, members of the company's administrative or management bodies or the experts that are responsible for reports submitted to the general meeting[573] might be liable to the company or its shareholders for any loss caused by breach of duty. However, shareholders are generally protected in other ways.

The appraisal remedy is the most important remedy available to dissenting shareholders. The appraisal remedy means that shareholders who dissent are given the right to have the fair value of their shares determined and paid to them in cash, provided that the shareholders comply with the statutory procedure.[574] EU merger law does not require such a remedy. However, Member States are free to adopt the appraisal remedy. According to the Third Company Law Directive, Member States' laws may permit the disclosure of less information to shareholders, if the minority shareholders of the entity that will not survive the merger are entitled to have their shares acquired by the acquiring company for a consideration corresponding to the value of their shares.[575]

Special remarks: the valuation of shares and the appraisal remedy. Legal rules on the valuation of shares belong to factors that shareholders of the company that will not survive the merger will take into account when deciding whether to vote against the merger and ask for a better price for their shares. For this reason, the form of consideration and the exchange ratio will be influenced by those rules.

EU merger law does not determine how exactly shares should be valued in the context of mergers. Generally, the valuation of shares is determined by the national provisions of Member States' laws (generally, see Chapter 10).

Review by competent authorities. In addition to the appraisal remedy and other remedies, shareholders may be protected through the review of the legality of the merger by the competent authorities. The existence of such a review could make it more difficult to breach minority shareholders' rights, and it could reduce the need of some of the other remedies.

However, EU merger law only requires Member States to adopt such a system in cross-border mergers (see below).

In public takeover bids, the legality of the transactions is monitored even by the competent authoritites that supervise capital markets.[576]

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572 Recital 9 of Directive 78/855/EEC (Third Company Law Directive). See also Article 22 of Directive 78/855/EEC (Third Company Law Directive); recital 8 and Article 17 of Directive 2005/56/EC (Directive on cross-border mergers); Article 30 of Regulation 2157/2001 (SE Regulation).

573 Article 21 of Directive 78/855/EEC (Third Company Law Directive).

574 See Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 192–193.

575 Article 28 of Directive 78/855/EEC (Third Company Law Directive). See also Article 25(3) of Regulation 2157/2001 (SE Regulation).

576 Article 4 of Directive 2004/25/EC (Directive on takeover bids).

The merger may require other permits such as competition law permits (Chapter 14) and securities law permits (section 5.9.3). In addition, competent competition law authorities and authorities supervising capital markets may be able to require the parties to provide information concerning the parties themselves.

Protection of the interests of creditors. The merger can have an adverse effect on the interests of creditors. If the borrower is loaded with debt after the merger, credit quality changes for the worse. For this reason, creditors and bondholders tend to insist on change of control covenants in their agreements (Volume II).

Creditors are also protected by the regulation of mergers in EU company law. According to the Third Company Law Directive, Member States' laws must provide for "an adequate system of protection of the interests of creditors of the merging companies whose claims antedate the publication of the draft terms of merger".[577]

Protection of the interests of employees. EU merger law protects even the interests of employees.

Both domestic and cross-border mergers are covered by a legal regime for informing and consulting employees. Rules on information and consultation can be found not only in EU labour law[578] but also in EU company law and capital markets law. For example, the likely effects of the merger on employment will have to be addressed in the draft terms of merger[579] and in the report of the management or administrative organ submitted to the general meeting.[580] SEs are subject to a more regulated employee involvement regime. Directive 2001/86/EC is designed to ensure that employees have a right of involvement in issues and decisions affecting the life of their SE.[581] In public takeover bids, both the offeror and the offeree must disclose information about the effects of the takeover on employment.[582]

In cross-border mergers, employees' participation rights raise further legal questions, because the existing participation rights of employees can range from a mandatory co-determination regime in Germany and the Netherlands to hardly any participation rights in England. EU merger law has adopted a before-after principle, according to which existing participation rights should be preserved after the merger.[583] For SEs, the before-after provisions are based on the provisions of Di-

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[577] Article 13 of Directive 78/855/EEC (Third Company Law Directive). See also Articles 14–16.

[578] Recital 12 of Directive 2005/56/EC (Directive on cross-border mergers). See also recital 23 of Directive 2004/25/EC (Directive on takeover bids).

[579] Article 5(d) of Directive 2005/56/EC (Directive on cross-border mergers); Article 32(2) of Regulation 2157/2001 (SE Regulation).

[580] Article 7 of Directive 2005/56/EC (Directive on cross-border mergers).

[581] Directive 2001/86/EC supplementing the Statute for a European company with regard to the involvement of employees. Recital 21 and Article 1(4) of Regulation 2157/2001 (SE Regulation).

[582] Articles 3(1)(b), 4(2)(e), 6(1), 6(2), 6(3)(i), 8(2), 9(5) and 14 of Directive 2004/25/EC (Directive on takeover bids).

[583] Recital 7 of Directive 2001/86/EC; recital 13 of Directive 2005/56/EC (Directive on cross-border mergers).

rective 2001/86/EC.[584] For other limited-liability companies, the before-after provisions are based on the Directive on cross-border mergers.[585]

In cross-border mergers, the competent authorities will scuritise even the legality of the arrangements for employee participation.[586]

Filings, filing of completion of the merger. A merger will trigger many filing duties. Filings are necessary in all mergers for two reasons. First, many steps of the merger require action taken by the competent authority and therefore also the filing of documents. Second, a merger must be made public.[587] Filings and disclosures are a means to protect the interests of shareholders, creditors, and employees.

The completion of the merger must be filed and made public by publishing it in the national gazette. The modalities of filing and publication depend on the governing law or laws.[588]

Listed companies must comply with the general disclosure regime that applies to listed companies (section 5.9). The Directive on takeover bids lays down further disclosure obligations. Those obligations apply both to the offeror and the offeree.

Effective date of merger. The date on which a domestic merger takes effect depends on the governing law. It is determined by Member States' laws.[589]

If the merger is a cross-border merger, it takes effect when the completion of the merger is registered after all formalities have been completed. For example, those formalities include the scrutiny of the legality of the merger.[590] The formation of a new SE takes effect on the date on which the new SE is registered.[591]

Company Law Aspects of Cross-border Mergers

Mergers are constrained by provisions of company law protecting shareholders and creditors, and by detailed rules on the modalities of the transaction. In addition, European merger laws typically protect employees. In domestic mergers, merger laws address those aspects in all participating companies in a coordinated way. A cross-border merger would involve the application of two or more countries' laws in a single legal operation and make it difficult to determine the applicable rules.

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[584] See, in particular, Articles 4 and 7.

[585] Article 16 of Directive 2005/56/EC (Directive on cross-border mergers).

[586] Article 11 of Directive 2005/56/EC (Directive on cross-border mergers).

[587] Article 18 of Directive 78/855/EEC (Third Company Law Directive); Article 6 of Directive 2005/56/EC (Directive on cross-border mergers); Articles 13, 15(2), 21 and 28 of Regulation 2157/2001 (SE Regulation).

[588] Article 18(1) of Directive 78/855/EEC (Third Company Law Directive); Article 13 of Directive 2005/56/EC (Directive on cross-border mergers); Article 28 of Regulation 2157/2001 (SE Regulation); Article 32 of Regulation 1435/2003 (SCE Regulation).

[589] Article 17 of Directive 78/855/EEC (Third Company Law Directive).

[590] Article 12 of Directive 2005/56/EC (Directive on cross-border mergers); Article 27 of Regulation 2157/2001 (SE Regulation); Article 31 of Regulation 1435/2003 (SCE Regulation).

[591] Article 12, 16 and 27 of Regulation 2157/2001 (SE Regulation).

In the past, company laws only rarely contained similar rules on cross-border mergers. In the absence of legal rules, cross-border mergers were prohibited. There was therefore a difference in treatment in most Member States between internal and cross-border mergers. This forced firms to own subsidiaries in the countries in which they did business or to choose the company form of an SE.

However, in *Sevic Systems*,[592] the prohibition of cross-border mergers was held to amount to discrimination of foreign companies. The ECJ did not think that a general refusal to register cross-border mergers or the harmonisation of the legislation at the Community level would be necessary,[593] although cross-border mergers can give rise to special problems.[594]

Mergers permitted. The judgment of the ECJ in *Sevic Systems*, in effect, forced Member States to permit cross-border mergers.[595] Cross-border mergers of limited-liability companies are now governed by the Directive on cross-border mergers.[596] This Directive applies to all companies governed by the First Company Law Directive (all limited-liability companies). Cross-border mergers are also governed by the SE Regulation[597] and the SCE Regulation,[598] as an SE can be formed by private or public limited-liability companies by means of a cross-border merger (Articles 2(1), 17 and 32) and an SCE can be formed by means of a cross-border merger of existing cooperative societies.

The entities that may merge to form an SE under the SE Regulation or an SCE under SCE Regulation may merge even under national law. As regards limited-liability companies in general, cross-border mergers are only possible if the participating companies may merge under national law.[599]

In rare cases, a cross-border merger may be prohibited on grounds of public interest (see below).

Governing law. In a domestic merger, the governing law is not an issue. In a cross-border merger, three jurisdictions can be relevant: the law that governs an entity that will not survive the merger; the law that governs the entity that will survive the merger; and the law of the entity that will be founded by the merger.

The judgment of the ECJ in *Sevic Systems*[600] did not change the governing law. If a company is formed in accordance with the law of a Member State and has its registered office, central administration or principal place of business within the Community, it must be recognised as a company governed by the law of that Member State.[601] To apply the company law provisions in force in another Mem-

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[592] Case C-411/03 Sevic Systems [2005] ECR I-10805, paragraph 23.
[593] Case C-411/03 Sevic Systems [2005] ECR I-10805, paragraph 26.
[594] Case C-411/03 Sevic Systems [2005] ECR I-10805, paragraphs 24 and 27. In principle, there might be circumstances in which imperative reasons in the public interest will justify a measure restricting the freedom of establishment. Paragrah 28.
[595] Case C-411/03 Sevic Systems [2005] ECR I-10805, paragraph 23.
[596] Directive 2005/56/EC (Directive on cross-border mergers).
[597] Regulation 2157/2001 (SE Regulation).
[598] Regulation 1435/2003 (SCE Regulation).
[599] Article 4(1)(a) of Directive 2005/56/EC (Directive on cross-border mergers).
[600] Case C-411/03 Sevic Systems [2005] ECR I-10805, paragraph 23.
[601] C-208/00 Überseering [2002] ECR I-9919, paragraphs 59 and 76.

ber State is permitted only in exceptional cases, that is, where their use is justified.[602]

This means that each company participating in a cross-border merger is governed by the law of the Member State to which it is subject. The law of one country will address one side of a cross-border merger (say, that of the entity that will not survive the merger), and the law of another country the other side of the merger (that of the entity that will survive the merger).

According to the SE Regulation, the formation of an SE by merger is primarily governed by the provisions of the SE Regulation. As regards aspects that are not covered by the SE Regulation, each company involved in the formation of an SE by merger is governed by "the provisions of the law of the Member State to which it is subject that apply to mergers of public limited-liability companies in accordance with Directive 78/855/EEC".[603] The same principle has been applied in the SCE Regulation.[604]

The Directive on cross-border mergers provides that "a company taking part in a cross-border merger shall comply with the provisions and formalities of the national law to which it is subject".[605]

Those rules are complemented by the scrutiny of mergers by competent authorities and an opposition procedure.

Review by competent authorities. There is a screening and monitoring mechanism for the legality of the merger.

The Directive on cross-border mergers provides for a pre-merger scrutiny of compliance with national law and a pre-merger certificate attesting to the proper completion of the pre-merger acts and formalities.[606] A competent authority will also scrutinise the legality of the formation of a new company resulting from the cross-border merger.[607] There are special provisions on the scrutiny of the share exchange ratio.[608]

Like the Directive on cross-border mergers, the SE Regulation[609] and the SCE Regulation require the scrutiny of mergers by competent authorities.[610]

Opposition by competent authorities. In addition, the Directive on cross-border mergers, the SE Regulation and the SCE Regulation enable the competent authorities of a Member State to oppose the merger.

According to the SE Regulation,[611] the laws of a Member State may provide that a company governed by the law of that Member State may not take part in the formation of an SE by merger if any of that Member State's competent authorities

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[602] C-167/01 Inspire Art [2003] ECR I-10155, paragraph 138.
[603] Article 19 of Regulation 2157/2001 (SE Regulation).
[604] Article 20 of Regulation 1435/2003 (SCE Regulation).
[605] Article 4(1)(b) of Directive 2005/56/EC (Directive on cross-border mergers).
[606] Article 10 of Directive 2005/56/EC (Directive on cross-border mergers).
[607] Article 11 of Directive 2005/56/EC (Directive on cross-border mergers).
[608] Article 10(3) of Directive 2005/56/EC (Directive on cross-border mergers).
[609] Articles 8(7), 8(8) and 25 of Regulation 2157/2001 (SE Regulation).
[610] Article 29 and 30 of Regulation 1435/2003 (SCE Regulation).
[611] Articles 8(14) and 19 of Regulation 2157/2001 (SE Regulation).

opposes it before the issue of that certificate. Such opposition may be based only on grounds of public interest. There is a similar rule in the SCE Regulation.[612]

The Directive on cross-border mergers provides that the "laws of a Member State enabling its national authorities to oppose a given internal merger on grounds of public interest shall also be applicable to a cross-border merger where at least one of the merging companies is subject to the law of that Member State".[613]

Tax and cross-border mergers. Like the company law aspects of cross-border mergers, the tax treatment of cross-border mergers is covered by the fundamental freedoms under the EC Treaty. In addition, the tax treatment of cross-border mergers is governed by Directive 90/434/EEC.[614]

The main principle under Directive 90/434/EEC is tax neutrality. It should be possible to carry out mergers and other types of restructuring without any immediate tax consequences. A merger shall not – of itself – give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their value for tax purposes,[615] nor shall it – of itself – give rise to any taxation of the income, profits or capital gains of the shareholders.[616]

If the provisions of Directive 90/434 are not implemented, companies participating in a merger may directly rely on any national rules that allow for tax neutrality in the case of a domestic merger.

On the other hand, artificial arrangements whose purpose is to circumvent or escape national tax law are not regarded as worthy of protection under EU tax law (*Marks & Spencer*).[617]

5.11.5 Share Exchanges and Company Law

A share exchange can be full or partial. A full share exchange permits a business combination between two or more entities. The entities can be domestic or foreign.

Effect of share exchange. The effect of a full share exchange is that: (1) the separate existence of the entities does not cease; and (2) the acquiring entity acquires all of the ownership interests of the securities classes issued by the other entities; (3) and, as a result of the exchange, the acquiring entity becomes the controlling entity.

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612 Article 21 of Regulation 1435/2003 (SCE Regulation).

613 Article 4(1)(b) of Directive 2005/56/EC (Directive on cross-border mergers).

614 Directive 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States.

615 Article 4(1) of Directive 90/434/EEC.

616 Article 8(1) of Directive 90/434/EEC.

617 Case C-446/03 Marks & Spencer [2005] ECR I-10837, paragraph 57.

A two-party share exchange requires the issuing of new shares or the sale of existing shares owned by the company itself. The legal framework can be complicated, and the share exchange process requires careful planning.

Issuing of new shares. If the company issues new shares, many questions can require a resolution by the *general meeting* under the European legal capital regime. (1) There must be a decision to issue new shares. The decision on the issuing of new shares will have to be complemented by other decisions. (2) There must be a decision on the withdrawal of existing shareholders' pre-emption rights and (3) a decision on the acceptance of a consideration other than in cash. (4) The decision to issue new shares can also require a decision to increase the legal capital of the company. (5) This may require the amendment of the articles of association. (6) Furthermore, it may be necessary to decide on stabilisation measures.

All such decisions require a certain amount of *disclosure* to existing shareholders and the general meeting. There can also be other forms of disclosure.

The issuing company may have to comply with securities markets laws applicable to public offers. Securities markets laws provide for the publication of an offer document or a prospectus and may require other forms of disclosure.

The *valuation* of the shares may be constrained by provisions of company or securities markets laws that protect shareholders in general or minority shareholders in particular.

As the share exchange process may trigger a duty to make a mandatory offer for the remaining shares, or the remaining shareholders' sell-out right under company or securities markets laws, the valuation of the shares will, in practice, be influenced by how it will affect the price that the firm will have to pay for the remaining shares.

For obvious reasons, the firm should *signal* both to its existing shareholders that it is in their interests to vote for the transactions, and to shareholders of the target company that it is in their interests to accept the offer.

It may also be necessary to apply for customary *regulatory approvals*. Where one of the parties is a listed company, the publication of an offer document or prospectus may require the consent of the competent authorities or the operator of the market place. There may be competition law aspects. In some regulated industries like banking, insurance, or defence, the change of control may require the consent of the competent authorities.

Mitigation of legal and commercial risk: general remarks. In practice, there are ways to simplify the process and mitigate legal and commercial risk.

First, the firm can ensure that the internal decisions can mostly be taken by the board of directors. This requires that the general meeting has, in advance, *empowered the board* to take those decisions.

According to the Second Company Law Directive, any increase in the authorised or subscribed capital must be decided on by the general meeting.[618] However, the board may be empowered to decide on the increase in the subscribed capital within certain limits and for a period not exceeding five years.[619]

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[618] Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).
[619] Article 25(2) of Directive 77/91/EEC (Second Company Law Directive).

The Second Directive further provides that "shares must be offered on a pre-emptive basis to shareholders in proportion to the capital represented by their shares" "whenever the capital is increased by consideration in cash".[620] Now, a share exchange means that the capital will not be increased "by consideration in cash". However, the laws of some Member States may provide that existing shareholders have pre-emption rights even in this case; in addition, they may provide that the board can be empowered to decide on the withdrawal of those pre-emption rights.[621] In practice, it would be legally more complicated to let the general meeting decide on the withdrawal of pre-emption rights. For example, there is the question of time. In addition, it would force the board to disclose more information. The Second Directive requires that the board present to the general meeting "a written report indicating the reasons for restriction or withdrawal of the right of pre-emption, and justifying the proposed issue price".[622]

Second, the firm can decide to make an *all-cash offer* or a *combined offer* instead. (a) From the perspective of the target's shareholders, the benefits of a share exchange offer depend on whether they want to become shareholders of the offeror in the first place. Their benefits also depend on the valuation of the offeror's shares and the target's shares. The valuations may change during the offer period. Generally, a share exchange offer is less transparent than an all-cash offer. If the target's shareholders can choose between competing offers, they might prefer an all-cash offer. (b) A share exchange is, of course, easier when the target is a privately-owned company, the offer is friendly, and there are no competing offers. (c) A share exchange offer means that the target's shareholders will become shareholders of the offeror. This can be in the interests of the offeror. However, the offeror's existing shareholders may prefer not to accept the dilution of their holdings. A share exchange can therefore be easier when the offeror is a large listed company with a controlling shareholder block rather than a listed company with a dispersed share ownership structure and activist shareholders (hedge funds), or a privately-owned company with controlling shareholders that want to hold on to their power.

Third, if the firm makes a share exchange offer, the firm should ensure that a sufficiently large number of the target's shareholders will *accept the offer*. (a) One of the differences between a share exchange offer and a formal merger is that the target's shareholders are free to accept the exchange offer or hold on to their shares. The firm may need a large block of shares in order to control the target. The size of the block depends on the governing law (Volume I). For this reason, share exchange offers tend to be conditional on the offeror obtaining, for example, more than 50%, more than two thirds, more than 75%, or more than 90% of the capital or votes of the target. (b) In addition, it would be in the interests of the firm to ensure that the target is contractually bound to co-operate. For example, the parties may agree on the duty to co-operate and the duty to pay a break-up fee should the deal collapse.

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[620] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).
[621] Article 29(5) of Directive 77/91/EEC (Second Company Law Directive).
[622] Article 29(4) of Directive 77/91/EEC (Second Company Law Directive).

This can be illustrated by Barclays' offer for ABN AMRO in 2007. The offer was conditional on Barclays obtaining at least 80% of the issued ordinary share capital of ABN AMRO as at the closing date of the offer on 4 October 2007. This condition was not fulfilled and, as a result, Barclays withdrew its offer. ABN AMRO paid Barclays a break-up fee of €200 million.

Fourth, the firm should ensure that it can assess *the total cost* of the share exchange offer. In particular, exceeding a certain threshold may trigger an obligation to make an offer for the remaining shares, a squeeze-out right, and/or a sell-out right. Whereas the offeror is free to propose the share exchange ratio under a voluntary offer, the offeror may have a legal obligation to pay at least a minimum amount under a mandatory offer. For this reason, the firm should ensure that the price that it pays for the target's shares before or during the share exchange offer and the share exchange ratio will not increase the minimum price that it will have to pay for remaining shares afterwards.

This can be illustrated by the Directive on takeover bids. According to the Takeover Bid Directive, a shareholder who has obtained control of a listed company must make a mandatory bid as a means of protecting the minority shareholders of that company.[623]

The minimum price that the shareholder must pay is the "equitable price". The equitable price has been determined in three ways. (1) The first is the highest price paid by the bidder before the bid: "The highest price paid for the same securities by the offeror, or by persons acting in concert[624] with him/her, over a period, to be determined by Member States, of not less than six months and not more than 12 before the bid …" (2) The second is the highest price paid by the bidder during the bid: "If, after the bid has been made public and before the offer closes for acceptance, the offeror or any person acting in concert with him/her purchases securities at a price higher than the offer price, the offeror shall increase his/her offer so that it is not less than the highest price paid for the securities so acquired." (3) Those two rules are complemented by the right of supervisory authorities to adjust the price.[625]

This means the bidder should not to pay too much for the target's shares before the commencement of the mandatory bid or during the bid.

On the other hand, the Takeover Bid Directive does not require the making of a mandatory bid where control has been acquired following a voluntary bid made in accordance with the Takeover Bid Directive to all the holders of securities for all their holdings.[626]

There are thus share exchange offers that will not trigger any obligation to make a mandatory bid even where the usual threshold is exceeded. A similar duty to make a bid may nevertheless be based on the target's articles of association (poison pill, see section 18.8).

In addition to the duty to make a mandatory bid in some cases, the Takeover Bid Directive also provides for a squeeze-out right and a sell-out right. Depending on the governing law, the threshold that triggers those rights can range from 90% to 95% of the capital carrying voting rights and of the voting rights.[627] The squeeze-out right and sell-out right will be

[623] Article 5(1) of Directive 2004/25/EC (Directive on takeover bids).
[624] For acting in concert, see section 19.9.
[625] Article 5(4) of Directive 2004/25/EC (Directive on takeover bids).
[626] Article 5(2) of Directive 2004/25/EC (Directive on takeover bids).
[627] Article 15(2) of Directive 2004/25/EC (Directive on takeover bids).

triggered where that threshold has been exceeded following the bid.[628] Those provisions may again be complemented by articles of association.

According to the statutory rules, the minimum price payable by the majority shareholder is in both cases the "fair price". Where the threshold has been exceeded following a mandatory bid, the consideration offered in the bid shall be presumed to be fair. Where the threshold has been exceeded following a voluntary bid, the consideration offered in the bid shall be presumed to be fair where, through acceptance of the bid, the offeror has acquired securities representing not less than 90% of the capital carrying voting rights comprised in the bid.

Where the target is a listed company, the offeror can thus mitigate legal risk by making it a condition of the share exchange offer that the offeror obtains a sufficient percentage of the capital carrying voting rights.

5.11.6 Share Exchanges and Securities Markets Law

If one of the participating companies is a listed company, parties to the merger or share exchange must comply with the provisions of EU securities markets law. Their application to share exchanges can be illustrated by the 2007 Eurotunnel case. The Eurotunnel case is very complicated and includes even a restructuring process. However, it is interesting, because it gives an opportunity to compare French and English law and to understand the common core of rules based on Community law.

The Eurotunnel case. In early 2007, Eurotunnel was an enterprise with two holding companies, Eurotunnel plc, an English company, and Eurotunnel SA, a French company. "Eurotunnel Units" comprising one share of Eurotunnel plc and one share of Eurotunnel SA were admitted to listing on the London Stock Exchange and Euronext, the Paris stock exchange.

On 15 January 2007, the Paris Commercial Court approved the restructuring of Eurotunnel. As part of the restructuring, Eurotunnel was to get a new group holding company, Groupe Eurotunnel SA (GET SA). GET SA would own all shares in Eurotunnel Group UK plc. The latter would function as a holding company in England.

The implementation of the restructuring meant: the listing in Paris and London of the shares in GET SA; the issue of hybrid Notes Redeemable in Shares (NRS) by Eurotunnel Group UK plc; and the launch of an Exchange Tender Offer (ETO) by GET SA for the shares in Eurotunnel SA and Eurotunnel plc.

GET SA was thus to launch an exchange tender offer for the shares in Eurotunnel SA and Eurotunnel plc.

Jurisdiction. There was a question of dual jurisdiction. Dual jurisdiction was caused by the structure of Eurotunnel and the transaction: the shares of Eurotunnel SA were admitted to trading on Eurolist by Euronext Paris; the shares of Eurotunnel plc were admitted to trading on the London Stock Exchange; the offer covered Units consisting of shares in both companies; one offeror and issuer (GET SA)

[628] Article 15(1) of Directive 2004/25/EC (Directive on takeover bids).

was a French company; one issuer of securities (Eurotunnel Group UK plc) was an English company; and shares in GET SA would be listed in Paris and London.

According to the Prospectus Directive, the "home Member State" is responsible for the approval of a prospectus.[629] The "home Member State" means usually the Member State where the issuer of securities to which the prospectus relates has its registered office.[630]

On the other hand, the main rule under the Directive on takeover bids is that the authority competent to supervise a bid is that of the Member State in which the target ("offeree") company has its registered office, if its securities are admitted to trading on a regulated market in that Member State.[631]

Part of the transaction fell therefore under the jurisdiction of the French supervisory authority (Autorité des marches financiers, AMF), and part under the jurisdiction of the English supervisory authorities (the Financial Services Authority or the Takeover Panel).

Because of dual jurisdiction and different requirements depending on the jurisdiction, the French and English authorities had to co-operate. It turned out that the competent authorities had to grant a number of exemptions.

Perspective. One can here choose the perspective of GET SA and study GET SA's share exchange offer.

Disclosure of decision to make a bid. As listed companies are subject to a strict disclosure regime, Eurotunnel plc and Eurotunnel SA disclosed the plan to the public.[632] GET SA had a duty to make its decision to make a bid public and inform the supervisory authority of the bid (see also section 19.8).[633]

Timetable. EU securities markets law does not lay down any particular timetable for public share exchange offers. The timetable of the bid was therefore governed by national provisons of Member States' laws. There were differences between English law and French law.

In England, the Takeover Code requires compliance with a very strict timetable.[634] The Takeover Panel which administers the Takeover Code nevertheless agreed that the timetable for GET SA's offer would be established by the AMF in accordance with the provisions of article 231–31 of the AMF General Regulations.

Prospectus before admission to trading. GET SA had to comply with listing and prospectus rules. According to the Prospectus Directive, the issuer, offeror or per-

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[629] Articles 2(1)(q) and 13(1) of Directive 2003/71/EC (Prospectus Directive).

[630] Article 2(1)(m)(i) of Directive 2003/71/EC (Prospectus Directive).

[631] Article 4(2)(a) of Directive 2004/25/EC (Directive on takeover bids).

[632] Article 6 of Directive 2003/6/EC (Directive on market abuse).

[633] Article 6(1) of Directive 2004/25/EC (Directive on takeover bids).

[634] As regards friendly bids, see in particular Rule 2.5 (the announcement of a firm intention to make an offer), Rule 2.6 (the target posts an announcement of a bid to its shareholders), Rule 30.1 (last day to post an offer document), Rule 31.1 (the first closing date for the offer), Rule 31.6 (last date on which the offer can be declared unconditional as to acceptances), and Rule 31.8 (last date for money or other consideration to be provided to the target's shareholders).

son asking for admission of securities to trading on a regulated market draw up a prospectus. The prospectus can be drawn up as a single document or separate documents. In some cases, there is an exemption from the obligation to publish a prospectus.[635]

Fast-track procedure. GET SA chose to prepare the prospectus as separate documents. This alternative provides a "fast-track procedure" for issuers.[636]

A prospectus composed of separate documents must divide the required information into a registration document, a securities note and a summary note. The registration document contains information relating to the issuer. The securities note contains information concerning the securities offered to the public or to be admitted to trading on a regulated market.[637]

Filing of registration document. According to the Prospectus Directive, "[n]o prospectus shall be published until it has been approved by the competent authority of the home Member State".[638] GET SA therefore filed a registration document with Autorité des marches financiers (AMF), the French supervisory authority.

AFM registered the registration document on 21 March 2007 and notified GET SA of its decision.[639] According to the Prospectus Directive, a registration document is valid for a period of up to 12 months.[640]

As GET SA already had a registration document approved by the competent authority, it only had to draw up the securities note and the summary note before securities were to be offered to the public or admitted to trading on a regulated market.[641]

Filing of securities note and summary. GET SA filed a securities note relating to the issue by GET SA and the admission to trading on Eurolist by Euronext of ordinary shares of GET SA. The securities note contained a summary. The AFM was again the competent authority. The AFM decided to approve the securities note on 4 April 2007 and notified GET SA of its decision.

Making the prospectus public before admission to trading. The approval of the registration document, the securities note and the summary meant that GET SA had obtained approval for a prospectus. The prospectus could now be made public.[642]

Both the registration document and the securities note contained a reference to the decision of the AFM. In the published part of its decisions, the AFM also noted that it was not responsible for the contents of the registration document and the securities note.[643]

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[635] See, in particular, Articles 4(2)(b) and (c) of Directive 2003/71/EC (Prospectus Directive).
[636] Recital 23 of Directive 2003/71/EC (Prospectus Directive).
[637] Article 5(3) of Directive 2003/71/EC (Prospectus Directive).
[638] Article 13(1) of Directive 2003/71/EC (Prospectus Directive).
[639] Article 13(2) of Directive 2003/71/EC (Prospectus Directive).
[640] Article 9(4) of Directive 2003/71/EC (Prospectus Directive).
[641] Article 12(1) of Directive 2003/71/EC (Prospectus Directive).
[642] Article 13(1) of Directive 2003/71/EC (Prospectus Directive).
[643] See Article 6 of Directive 2003/71/EC (Prospectus Directive).

Prospectus before offering securities to the public. GET SA had now complied with its obligations to publish a prospectus relating to the admission to trading of GET SA's ordinary shares.

The Prospectus Directive requires the publication of a prospectus also before securities are *offered to the public*.[644] The detailed contents of the prospectus are based on Regulation 809/2004.

Simplifying the prospectus requirements. The Prospectus Directive nevertheless contains exemptions.[645] The prospectus requirement does not apply provided that certain conditions are met.

In order to meet the conditions, it was already stated in GET SA's securities note (see above) that the securities were *not offered to the public* according to the Prospectus Directive:

"None of the GET SA Ordinary Shares … have been or will be offered or sold to the public in any member state of the European Economic Area … which has implemented [the Prospectus Directive], other than by application of the following exemptions provided for by the Prospectus Directive where the relevant exemption has been implemented by the relevant EEA Member State: - to legal persons approved or regulated as operators on financial markets as well as to non-approved or regulated entities involved only in the placement of shares;[646] - to legal persons who meet two of the following three conditions: having (a) an average number of employees for the last financial period of greater than 250, (b) total profits of more than 43 million euros or (c) a net annual turnover of more than 50 million euros;[647] - to fewer than 100 natural or legal persons, other than qualified investors as defined in the Prospectus Directive;[648] - in any other circumstance falling within article 3.2 of the Prospectus Directive ..."

Furthermore, one of the exemptions under the Prospectus Directive applies to exchange offers in connection with a *takeover*. The obligation to publish a prospectus does not apply to offers of securities to the public of "securities offered in connection with a takeover by means of an exchange offer, provided that a *document is available* containing information which is regarded by the competent authority as being equivalent to that of the prospectus, taking into account the requirements of Community legislation".[649]

Instead of a prospectus, GET SA could therefore publish an *offer document*. This enabled GET SA to avoid the application of some of the strict Community-wide rules.

It can be noted that the Prospectus Directive requires the disclosure of information even when it does not require the publication of a prospectus. Disclosure can be mandatory according to takeover or merger rules or the following provision giving effect to the principle of equivalent treatment: "material information

[644] Article 1(1) of Directive 2003/71/EC (Prospectus Directive).

[645] Articles 3 and 4 of Directive 2003/71/EC (Prospectus Directive). Article 2 sets out the scope of the Directive.

[646] Articles 3(2)(a) and 2(1)(e)(i) of Directive 2003/71/EC (Prospectus Directive).

[647] Articles 3(2)(a), 2(1)(e)(v) and 2(1)(f) of Directive 2003/71/EC (Prospectus Directive).

[648] Articles 3(2)(b) of Directive 2003/71/EC (Prospectus Directive).

[649] Article 4(1)(b) of Directive 2004/25/EC (Directive on takeover bids).

provided by an issuer or an offeror and addressed to qualified investors or special categories of investors, including information disclosed in the context of meetings relating to offers of securities, shall be disclosed to all qualified investors or special categories of investors to whom the offer is exclusively addressed".[650]

Offer document in public takeover bids. According to the Directive on takeover bids, the holders of securities to which the bid applies should be *properly informed* of the terms of a bid by means of an offer document. Before the offer document is made public, the offeror must communicate it to the *supervisory authority*.[651] Where the offer document is subject to the prior approval of the supervisory authority and has been approved, it will be *recognised* in the other Member States.[652]

Approval of the terms of the offer by the board. Before the filing of the offer document, GET SA's board of directors had to approve the terms of the offer.

The principal terms of the offer were as follows: the initial acceptance period ran from 10 April until 15 May 2007; for each Eurotunnel Unit tendered to the offer the holder was entitled to: one GET SA ordinary share and a warrant for GET SA ordinary shares; and the acceptance threshold for the Offer was 60% of the outstanding Units.

In addition, there were incentives to accept the offer during the initial period. French law provides for an initial acceptance period and an additional period (see below). Holders of Eurotunnel Units were told that if they tendered their Units to the offer during the initial acceptance period (excluding the additional acceptance period), they would have the right to subscribe, in cash and within certain limits, for notes redeemable in GET SA ordinary shares (NRS). It was pointed out that the right to subscribe for notes redeemable in GET SA ordinary shares did not form part of the consideration offered to holders of Eurotunnel Units and that those NSR were only available for subscription by shareholders having tendered their Units to the offer during the initial period.

A further incentive to accept the offer was a recapitalisation process that would be launched after the completion of the offer as part of the restructuring plan approved by the Paris Commercial Court. The recapitalisation process would dilute the holdings of existing shareholders.

Content of the offer document, conditions. According to the Directive on takeover bids, the offer document must generally contain "the information necessary to enable the holders of the offeree company's securities to reach a properly informed decision on the bid".[653] Appropriate information should also be given to the representatives of the company's employees or the employees directly.[654] The Directive on takeover bids sets out the minimum content of the offer document.

According to Article 6(3) of the Directive, the offer document should state at least: (a) the terms of the bid; (b) the identity of the offeror; (c) the securities for which the bid is made; (d) the consideration offered; (f) the maximum and minimum percentages or quantities of

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[650] Article 15(5) of Directive 2003/71/EC (Prospectus Directive).
[651] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).
[652] Article 6(1) of Directive 2004/25/EC (Directive on takeover bids).
[653] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).
[654] Recital 13 of Directive 2004/25/EC (Directive on takeover bids).

securities which the offeror undertakes to acquire; (g) details of any existing holdings of the offeror in the offeree company; (h) all the conditions to which the bid is subject; (i) the offeror's intentions with regard to the future business of the offeree company and, in so far as it is affected by the bid, the offeror company; the offeror's strategic plans for the two companies and the likely repercussions on employment and the locations of the companies' places of business; and the offeror's intentions as regards jobs and material changes in the conditions of employment; (j) the time allowed for acceptance of the bid; (k) where the consideration offered by the offeror includes securities of any kind, information concerning those securities; (l) information concerning the financing for the bid; (m) the identity of persons acting in concert with the offeror or with the offeree company; (n) the national law which will govern contracts concluded between the offeror and the holders of the offeree company's securities as a result of the bid and the competent courts.

The offer was subject to a number of *conditions*: an acceptance condition (valid acceptances in respect of not less than 60% of Eurotunnel units); the passing of resolutions authorising the issue of shares in GET SA (the board of directors of GET SA had approved the offer and convened an extraordinary meeting of shareholders to pass resolutions authorising the issue of new shares); limited withdrawal rights;[655] and the condition that the reorganisation of Eurotunnel would not fail. (For conditions generally, see section 19.10.)

Formal approval of the offer document. The nature of the Units again meant that both the AMF (insofar as the offer related to shares in Eurotunnel AS) and the Takeover Panel (insofar as the offer related to shares in Eurotunnel plc) were competent authorities.[656] GET SA could therefore not directly benefit form the principle that an offer document approved by the competent authority in one Member State must be recognised in other Member States.[657] The dual jurisdiction forced the AMF and the Takeover Panel to cooperate.

The terms of the offer launched by GET SA and the related offer document were subject to formal approval by the AMF before the opening of the offer for acceptances.[658] Following the filing of the registration document relating to GET SA with the AMF on 21 March 2007, GET SA filed the offer with the AMF on 23 March 2007. The offer document was approved by the AMF on 3 April 2007.[659]

In England, the Takeover Panel agreed to waive the application of several rules. For example, the Takeover Panel agreed that the timetable relating to the offer would be established by the AMF in accordance with the provisions of article 231–31 of the General Regulations of the AMF rather than the strict rules of the Takeover Code. In addition, the Takeover Panel waived Rule 13 of the Takeover

[655] In the event that the offer had become without object (deviant sans objet) or Eurotunnel SA or Eurotunnel plc had adopted measures that modified their substance (en raison des measures qu'elle a prises, voit law constance modifiée). See article 232–11 of the AMF General Regulations,

[656] Article 4(2)(a) of Directive 2004/25/EC (Directive on takeover bids).

[657] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).

[658] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).

[659] In accordance with the provisions of articles L. 621–8 of the French Monetary Code and article 231–23 of the AMF General Regulations.

Code that limited the circumstances in which the offer could lapse or be withdrawn.

Publication of the offer document. The offer document could now be made public.[660] The next step was the opinion of the targets' boards.

Opinion of the targets' boards. According to the Directive on takeover bids, the board of the target ("offeree") company must "draw up and make public a document setting out its opinion of the bid and the reasons on which it is based, including its views on the effects of implementation of the bid on all the company's interests and specifically employment, and on the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the company's places of business". In addition, the board of the offeree company must "at the same time communicate that opinion to the representatives of its employees or, where there are no such representatives, to the employees themselves".[661]

The Joint Board of Eurotunnel (the board of Eurotunnel plc and Eurotunnel SA) unanimously recommended to Unitholders that they tender their Units to the offer launched by GET SA.

The time allowed for acceptance of the bid. The initial acceptance period ran from 10 April until 15 May 2007. With the permission of the AMF, GET SA announced that the offer would remain open for acceptances until 21 May 2007.[662]

Resolutions of the offeror's general meeting. On 23 April 2007, the extraordinary general meeting of Groupe Eurotunnel SA (GET SA) and that of its subsidiary Eurotunnel Group UK plc (EGP) were held. The general meetings conferred on the boards of directors of GET SA and EGP the authority necessary to issue the relevant securities described in the Securities Note.[663]

Change of conditions. With the permission of the AMF, the acceptance condition for the offer was reduced from 60% to 50% of the outstanding Eurotunnel Units.[664]

Suspension of share trading. On 22 May 2007, the tender offer for Eurotunnel Units had closed and the parties were waiting for the results of the offer to become clear. AMF decided to suspend trading in Eurotunnel shares to protect the markets. Because of Eurotunnel's bi-national nature, the suspension of share trading was extended to the London Stock Exchange.[665]

Publication of the provisional results of the offer. On 25 May 2007, the provisional results of the offer were published by the AMF.[666] Around 87% of the share capital of Eurotunnel SA and Eurotunnel plc was tendered to the offer. In practice, the provisional results meant that Eurotunnel was saved from financial ruin.

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[660] Articles 6(2) and 8 of Directive 2004/25/EC (Directive on takeover bids).
[661] Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).
[662] See Articles 6(2), 6(3)(j) and 7 of Directive 2004/25/EC (Directive on takeover bids).
[663] Articles 25(2) and 29(5) of Directive 77/91/EEC (Second Company Law Directive).
[664] See Article 6(3)(h) of Directive 2004/25/EC (Directive on takeover bids).
[665] See Articles 41 and 50(2)(j) of Directive 2004/39/EC (MiFID).
[666] Article 13(d) of Directive 2004/25/EC (Directive on takeover bids).

Recommencement of share trading for Eurotunnel Units. Following the publication of the provisional results of the exchange tender offer, the English and French market authorities (FSA and AMF) decided that trading in the Units could recommence from 29 May 2007.

Publication of the final result of the initial acceptance period. The final results of the initial acceptance period of the exchange tender offer were published by the AMF on 31 May 2007. Units representing 87.29% of the share capital in circulation were tendered to the offer.

Reopening of the bid under French law. Under French law, the bid was reopened automatically. Shareholders in Eurotunnel plc and Eurotunnel SA who had not yet tendered their shares to the offer had the opportunity to do so in the second acceptance period from 1 June to 14 June 2007.

The reopening of the bid gave those who had not yet tendered their Units a chance to avoid becoming a small minority with illiquid shares. At the same time, the reopening of the bid gave GET SA a change to reduce the size of the minority block and thus to make it easier to take Eurotunnel SA and Eurotunnel plc private and use squeeze-out rights.

The conditions of the offer remained identical to the original offer. Remaining shareholders of Eurotunnel SA and Eurotunnel plc could tender their Units of Eurotunnel SA and Eurotunnel plc on the following terms: one GET SA ordinary share for one Eurotunnel Unit; and one warrant to subscribe for GET SA ordinary shares for each Eurotunnel Unit tendered.

However, notes redeemable in shares (NRS) were only available for subscription by shareholders having tendered their Units to the offer during the initial period.

Publication of the final results of the exchange tender offer. The final results of the exchange tender offer were published by the AMF on 21 June 2007. Units representing 93.04% of the share capital of Eurotunnel SA and Eurotunnel plc were tendered.

Applying for a listing of GET SA shares and warrants. As the settlement of the offer would occur on 28 June 2007, GET SA submitted an application to Euronext for the initial listing of its shares and warrants and requested that the initial listing should take place on 2 July 2007 (for listing requirements and the competent authorities, see section 5.9.2).

Settlement, issuing of new GET SA shares and warrants. The settlement of the exchange tender offer and the financial restructuring took place on 28 June 2007. On that date, the parties took most of the steps to implement the Eurotunnel Safeguard Plan that was approved by the Paris Commercial Court. In particular, the settlement of the exchange tender offer meant that new GET SA shares and warrants were issued in exchange for Units tendered to the offer.

Admission of GET shares and warrants to trading (listing). The securities were admitted to trading following the completion of the final formalities required for the implementation of the Safeguard Plan. The first admission of the securities to trading took place on 2 July 2007.

Shares and warrants issued by GET SA were admitted to trading on Eurolist by Euronext.

There was a secondary listing on the London Stock Exchange.[667] Investors who wanted to invest in the Groupe Eurotunnel SA but trade their securities in London could buy CREST[668] Depository Interests (CDIs) through a financial intermediary. The CDIs represented a right to one share and/or warrant in GET SA.

The notes redeemable in GET SA shares issued by Eurotunnel Group UK plc were admitted to trading on Eurolist by Euronext and on the London Stock Exchange.

Delisting of Eurotunnel Units. Following the implementation of the Reorganisation Plan, GET Eurotunnel SA was the holder of over 90% of the Eurotunnel SA and Eurotunnel plc Units. The market for the Units no longer met the liquidity requirements for the listing of the Units on Eurolist by Euronext or the Official List of the UK Listing Authority (FSA) or their admission to trading on the London Stock Exchange.

This meant that there was a reason to delist them.[669] Holders of Eurotunnel Units were first told that the listing of the Units may be cancelled. They were then informed of the cancellation of the listing in London and of the commencement of a notice period of 20 business days.[670] Information about the delisting was also given to the general meetings of Eurotunnel SA and Eurotunnel plc. On 29 July 2007, GET SA, the holder of more than 90% of shares in Eurotunnel SA and Eurotunnel plc, filed an application with the UK Listing Authority (FSA) for the cancellation of the listing of the Eurotunnel Units in London.[671] The UK Listing Authority confirmed that delisting would become effective on 30 July 2007.

5.11.7 Fairness, Price, Existence of a Market

Company and securities markets laws tend to address questions of fairness, price and the existence of a market in the context of mergers and share exchanges, because these questions are relevant for shareholders in the participating companies.

Where a company takes over another company (the target) by issuing new shares to the target's shareholders, the company will obtain new shareholders and the holdings of its existing shareholders will be diluted. The company's existing shareholders are likely to lose, if the harm sustained by them directly or indirectly will not be compensated through direct or indirect benefits.

For example, the offeror company's existing shareholders may lose *directly*, if: the share exchange ratio is too high (too many shares for one share in the target); or they lose a qualified majority or minority which enabled them to take important decisions or block them.

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[667] For secondary listings under the Listing Rules, see LR 14.

[668] CREST is the UK's electronic settlement systems for shares and certain other securities. CREST is operated by CRESTCo Limited in accordance with the Uncertificated Securities Regulations 2001 (as amended).

[669] Article 41(1) of Directive 2004/39/EC (MiFID). For English law, see LR 5.2.2 G.

[670] LR 5.2.7 R.

[671] LR 5.2.2 G.

Its shareholders may lose *indirectly*, if: the company pays too much in other ways (too much cash for one share in the target); the company does not benefit sufficiently from the ownership of the target (dilution of profits); or the company does not benefit sufficiently from its changed ownership structure.

In the target company, shareholders may be worse off, if: they are forced to sell their shares; they do not get sufficient compensation for their shares; or (if they keep their shares) there will not be any market left for their shares or the market will be less efficient.

Company and securities markets laws can help to address such concerns. There may be mechanisms that help to ensure that the transaction is perceived as fair, that the price is fair, and that the target's shareholders do not end up owning shares for which there is no market. Depending on the circumstances, common methods adopted by the legislator include: disclosure; the vesting of the power to decide on the transaction in shareholders; the use of external information intermediaries that analyse the fair value of the shares; and various kinds of duties to buy or sell-out rights. In Europe, the legal capital regime has an important role to play.

There are differences between formal mergers and share exchange offers on one hand, and the protection of the interests of shareholders in different participating companies on the other.

Mergers. In formal mergers, both shareholders in the surviving entity and shareholders in the entity that will cease to exist will be affected. Shareholders in both companies are protected by the provisions of EU company law. The rules that govern internal decision-making in the context of mergers have partly been harmonised. In addition, shareholders in the surviving company are protected by the legal capital regime according to which many questions relating to shares and legal capital must be decided on by shareholders (section 5.4).

Table 5.2 Protection of Shareholders in a Merger

	Protection of shareholders in the surviving entity	*Protection of shareholders in the entity that will cease to exist*
Disclosure of information ex ante	(General duties of listed companies to disclose information.) Disclosure of draft terms of merger. Disclosure of other information to the general meeting.	(General duties of listed companies to disclose information.) Disclosure of draft terms of merger. Disclosure of other information to the general meeting.
Specific constraints on price ex ante	No issue at a price lower than nominal value or accountable par value.[672]	Limited rights to a cash consideration
Decision rights	The merger will be decided on by the general meeting. The general meeting will decide on the issuing of new shares (the board may have been authorised to decide on it). The general meeting may have to decide on the waiving of pre-emption rights (the Second Company Law Directive does not require it here). The general meeting may have to decide on the amendment of articles of association.	The merger will be decided on by the general meeting.
Right to contest resolutions ex post	Very limited opportunities to undo the merger.	Very limited opportunities to undo the merger.
Other remedies ex post	Use of remedies that generally apply to the actions of board members.	Review by the court of the value of shares. Consideration in cash.

Share exchange offers. As regards share exchange offers, the offeror's shareholders are again protected by the European legal capital regime. According to the Second Company Law Directive, existing shareholders have pre-emptive rights.[673] The general meeting decides on the withdrawal of shareholders' pre-emptive rights[674] and on any increase in authorised capital.[675] Alternatively, the general meeting can authorise the board to decide on those questions.[676]

[672] Article 8(1) of Directive 77/91/EEC (Second Company Law Directive).
[673] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).
[674] Article 29(4) of Directive 77/91/EEC (Second Company Law Directive).
[675] Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).
[676] Articles 25(2) and 29(5) of Directive 77/91/EEC (Second Company Law Directive).

If the target ("offeree") is a listed company, its shareholders will be protected by their right to decide on the transaction; in a share exchange offer, each shareholder will nevertheless decide whether to accept the offer or not.

In addition, the Directive on takeover bids lays down general principles for the protection of holders of the target's securities and requires the publication of an offer document and information. The target's shareholders will also be protected ex post against loss of an effective market for their shares (mandatory bids, sell-out rights). The application of such provisions requires the valuation of their shares (see section 19.10).[677]

Table 5.3 Protection of Shareholders in a Share Exchange Offer

	Protection of the offeror's shareholders	*Protection of the target's shareholders*
Disclosure of information ex ante	(General duties of listed companies to disclose information.) Disclosure of information to the general meeting. Independent experts report.[678]	(General duties of listed companies to disclose information.) General duty to give sufficient information to shareholders.[679] Publication of a prospectus before admission of securities to listing. Publication of an offer document. Possibly, a fairness opinion under national rules. Opinion of the target's board.
Specific constraints on price ex ante	No issue at a price lower than nominal value or accountable par value.[680]	In listed companies, principle of equivalent treatment of holders of securities that belong to the same class. In listed companies, prohibition of partial offers depending on the governing law.[681] Valuation of shares ex post (see below) will influence the valuation of shares ex ante.

677 Article 3(1) of Directive 2004/25/EC (Directive on takeover bids).
678 Articles 27(2) and 10(3) of Directive 77/91/EEC (Second Company Law Directive).
679 Article 3(1)(b) of Directive 2004/25/EC (Directive on takeover bids).
680 Article 8(1) of Directive 77/91/EEC (Second Company Law Directive).
681 Article 5(1) of Directive 2004/25/EC (Directive on takeover bids) prohibits partial offers only in the context of mandatory bids.

Decision rights	The general meeting will decide on the issuing of new shares (the board may have been authorised to decide on it). Possibly, the general meeting may have to decide on the waiving of pre-emption rights (the board may have been authorised to decide on it or pre-emption rights may not apply).[682] The general meeting may have to decide on the amendment of articles of association.	Each shareholder has discretion to sell shares or keep them; no obligation to sell shares to the offeror.
Right to contest resolutions ex post	Limited rights to contest resolutions taken by the general meeting.	
Withdrawal rights		In some jurisdictions, limited withdrawal rights depending on the governing law.[683]
Other remedies ex post	Use of remedies that generally apply to the actions of board members.	Lack of market for shares: The exceeding of a threshold may trigger a statutory duty to make a mandatory bid. The exceeding of a threshold may trigger a duty to make a mandatory bid under articles of association (poison pill). The exceeding of a threshold may trigger a squeeze-out right and/or a sell-out right. Smaller free float may lead to delisting. Price: Rules on valuation of shares in the event that rules on mandatory bids, squeeze-out right or sell-out right become applicable.

The terms of the share exchange offer may be constrained by the articles of association of the target. Articles of association can lay down an additional duty to make a mandatory bid or provide for sell-out rights. Such clauses serve three purposes.

First, provisions on mandatory bids or sell-out rights can serve as a takeover defence (section 18.4) by making the takeover more expensive.

Second, sell-out rights can protect minority shareholders in the event of a sudden reduction in the free float. For example, the articles of association of Nokia

[682] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).
[683] Article 13 of Directive 2004/25/EC (Directive on takeover bids).

Corporation, a Finnish company, provide for sell-out rights in the event of a takeover.[684]

Third, such clauses complement the statutory provisions that implement the provisions of the Directive on takeover bids.

The Directive provides that the obligation to launch a mandatory bid does not apply where "control has been acquired following a voluntary bid made in accordance with this Directive to all the holders of securities for all their holdings".[685] The articles of association may require the making of a bid even where control has been acquired in that way or lay down a lower threshold. Furthermore, the Directive on takeover bids only requires squeeze-out rights and sell-out rights where a certain high threshold has been exceeded "following a bid made to all the holders of the offeree company's securities for all of their securities".[686] The articles of association of the company may provide for a lower threshold and give shareholders a sell-out right even where the threshold has been exceeded in other ways than following a bid.

Special remarks: fairness. Whereas shareholders decide on the terms of merger, the target company's shareholders will not decide on the terms of a share exchange offer. As the offeror is basically free to decide on the terms of the offer, the target's shareholders are in a weaker bargaining position than shareholders in a formal merger would be.

If the target is a listed company, this question has been addressed by the regulation of public takeover bids in general and the principle of fairness in particular. A substantial part of tender offer regulation is based on the underlying notion of fairness. However, fairness is a subjective notion, and there are differences between different countries' laws.[687]

The provisions of the Directive on takeover bids are designed to promote fairness in various ways (equivalent treatment,[688] restrictions on partial offers,[689] equitable price in mandatory bids,[690] sell-out right at fair value[691]).

There can be differences between Community law and US law. (a) For example, Rule 14e–5 prohibits, in connection with a tender offer for equity securities, a bidder from purchasing or arranging to purchase any of the target's securities outside of the tender offer. Although the provisions of the Directive on takeover bids do not expressly prohibit the offeror from

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684 Article 13 of the Articles of Association of Nokia Corporation.

685 Article 5(2) of Directive 2004/25/EC (Directive on takeover bids).

686 Articles 15(1) and 16(1) of Directive 2004/25/EC (Directive on takeover bids).

687 Ogowewo TI, The Underlying Themes of Tender Offer Regulation in the United Kingdom and the United States of America, JBL 1996 pp 463–481.

688 Article 3(1) of Directive 2004/25/EC (Directive on takeover bids).

689 Article 3(1)(a) of Directive 2004/25/EC (Directive on takeover bids): "… all holders of the securities of an offeree company of the same class must be afforded equivalent treatment …"; Article 5(1): "… Such a bid shall be addressed … to all the holders of those securities for all their holdings …" Article 15(2): "Member States shall ensure that an offeror is able to require all the holders of the remaining securities to sell him/her those securities at a fair price ..."

690 Article 5(4) of Directive 2004/25/EC (Directive on takeover bids).

691 Article 16 of Directive 2004/25/EC (Directive on takeover bids).

purchasing target securities form a certain shareholder at a higher price during the duration of the offer, the provisions of the Directive ensure that the offeror must offer to pay the same price to holders of securities of the same class. (b) Unlike the Williams Act of 1968,[692] the Directive on takeover bids requires a mandatory bid. Furthermore, it restrains partial bids.[693] (c) In addition, the Directive goes further in ensuring shareholder sovereignty by curtailing unauthorised managerial resistance. In the US, constitutional reasons may explain this difference, as such rules could interfere with State corporation law.

Special remarks: fair value. The form of consideration, the valuation of shares, and the exchange ratio will be influenced by legal rules governing such matters. Compliance is necessary for two reasons. Shareholders of the target will take such rules into account when deciding how to vote on a merger or whether to accept a share exchange offer. Furthermore, compliance is necessary in order to reduce legal risk: virtually all squeeze-out processes in Germany are contested and reviewed by the court.

It goes without saying that company laws cannot fix the price of shares. Company laws can only address some aspects of valuation. There is a difference between mergers and share exchange offers in this respect.

Community law does not determine how exactly shares should be valued in the context of mergers.

Community law addresses the valuation of shares in the context of some share exchange offers. However, such rules only cover a number of special situations such as mandatory bids and the exercise of squeeze-out rights and sell-out rights, and Member States may lay down provisions more favourable to holders of securities than those of the Directive.[694]

In some cases, a large shareholder whose share ownership exceeds a certain threshold must make a *mandatory bid* under provisions implementing the Directive on takeover bids for all transferable securities carrying voting rights in the company (see section 19.10). The offeror must pay at least an "equitable price".[695] "Equitable price" has been defined as follows: "The highest price paid for the

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692 Williams Act of 1968 is an amendment of the Securities and Exchange Act of 1934 that regulates tender offers and other takeover related actions such as larger share purchases. In addition, tender offers are regulated by the State Takeover Statutes.

693 Ogowewo TI, The Underlying Themes of Tender Offer Regulation in the United Kingdom and the United States of America, JBL 1996 pp 463–481. "A further reason for the variance in approach - especially in regard to partial bids - may be historical. In the United Kingdom, the tender offer emerged as a mechanism for taking over or merging entire undertakings of companies. The offers were predominantly full offers, conditioned on 90 per cent acceptance so as to take advantage of the compulsory acquisition provisions. In the United States, take-overs were usually effected through the statutory merger route. The tender offer emerged mainly as a way of removing incumbent management, and therefore performing quite efficiently that which proxy contests had failed to do. For one to gain control of a company, a partial bid was usually enough. And if a true consolidation was later desired, a statutory merger could be effected. Thus, partial bids were not looked upon as an exception."

694 Article 3(2) of Directive 2004/25/EC (Directive on takeover bids).

695 Article 5 of Directive 2004/25/EC (Directive on takeover bids).

same securities by the offeror … over a period, to be determined by Member States, of not less than six months and not more than 12 before the bid … If, after the bid has been made public and before the offer closes for acceptance, the offeror … purchases securities at a price higher than the offer price, the offeror shall increase his/her offer so that it is not less than the highest price paid for the securities so acquired."[696]

However, the obligation to launch a mandatory bid will not apply, where "control has been acquired following a *voluntary bid* made in accordance with [the Directive on takeover bids] to all the holders of securities for all their holdings".[697]

Where an offeror has made a public takeover bid, become a majority shareholder as a result of the bid, and obtained a *squeeze-out right* as set out in the Directive on takeover bids,[698] the price that the majority shareholder must pay to minority shareholders for their shares must be "fair".[699]

The consideration will nevertheless depend on whether the *earlier bid* was voluntary or mandatory. If the earlier bid was mandatory, the consideration offered in the bid is presumed to be fair. If the earlier bid was voluntary, the consideration offered in the earlier bid is presumed to be fair where, through acceptance of the bid, the offeror acquired securities representing not less than 90% of the capital carrying voting rights.

Again, the obligation to purchase (sell-out right) or sell (squeeze-out rights) shares will not apply, where the threshold was exceeded other than as a result of "a bid made to all the holders of the offeree company's securities for all of their securities".

Where the provisions implementing the squeeze-out right or sell-out right under the Directive on takeover bids do apply, the offeror may have no incentive to pay a higher price to one shareholder. The presumption in the Directive on takeover bids thus lays down the minimum price and, in practice, also the maximum price that the offeror is prepared to pay.[700]

Where the provisions on squeeze-out rights and sell-out rights do not apply, the price can be determined in another way. In those cases, consideration for shares can depend on the governing law.

Under Norwegian law, the price payable in a squeeze-out or sell-out situation is the "true value" (virkelig verdi) of shares. According to the judgment of the Supreme Court (Høysterett) in the case of *Norway Seafoods*, the shares must, in that context, be valued as if the company did not have a controlling shareholder.[701] When the transfer of shares is subject to the company's consent and the consent is not given, the shareholder may require the company to redeem his shares. In that context, the main rule according to the judgment in the

[696] Article 5(4) of Directive 2004/25/EC (Directive on takeover bids).
[697] Article 5(2) of Directive 2004/25/EC (Directive on takeover bids).
[698] Articles 15 (squeeze-out) and 16 (sell-out) of Directive 2004/25/EC (Directive on takeover bids).
[699] Article 15(5) of Directive 2004/25/EC (Directive on takeover bids).
[700] See nevertheless Article 3(2) of Directive 2004/25/EC (Directive on takeover bids) on more stringent requirements.
[701] Rt 2003 p 713 (Norway Seafoods). See also Chapter 4, section 25 of allmennaksjeloven.

case of *Flesberg* is that the "true value" (virkelig verdi) of shares is determined on the basis of their market value.[702]

Where the *articles of association* of the target provide for an obligation to launch a mandatory bid or for sell-out rights, the articles of association tend to set out how the price will be determined.

Special remarks: fairness opinion, independent advice. In formal mergers, the merger plan will be reviewed by independent experts who will submit a report to the general meeting.[703]

Whether an external fairness opinion or the publication of independent advice are required in share exchange offers depends on whether the issuing of shares is governed by the Second Company Law Directive, whether the offer is a public bid governed by the Directive on takeover bids, and the governing law.

The Second Directive requires the drawing up of a report on any consideration other than in cash by one or more independent experts.[704] After the partial modernisation of the Directive in 2006,[705] that report has become optional for Member States: where the consideration consists of securities admitted to trading on a regulated market or money market instruments and they are valued at a certain weighted average price; or where the consideration consists of other assets which have already been subject to a fair value opinion.[706]

For example, Member States may decide not to apply that requirement "where, upon a decision of the administrative or management body, assets … have already been subject to a fair value opinion by a recognised independent expert and where the following conditions are fulfilled: (a) the fair value is determined for a date not more than six months before the effective date of the asset contribution; (b) the valuation has been performed in accordance with generally accepted valuation standards and principles in the Member State, which are applicable to the kind of assets to be contributed." In the case of new qualifying circumstances that would significantly change the fair value of the asset at the effective date of its contribution, a revaluation must be carried out.[707]

In the absence of an expert's report, a declaration containing the following must be published within one month after the effective date of the asset contribution: "(a) a description of the consideration other than in cash at issue; (b) its value, the source of this valuation and, where appropriate, the method of valuation; (c) a statement whether the value arrived at corresponds at least to the number, to the

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[702] Rt 2007 p 1392 (Flesberg). Generally, see Truyen F, Vederlaget ved innløsning av aksjer: Hvor langt rekker Flesberg-dommen? NTS 2008:1 pp 62–70.

[703] Article 10 of Directive 78/855/EEC (Third Company Law Directive); Article 8 of Directive 2005/56/EC (Directive on cross-border mergers); Article 22 of Regulation 2157/2001 (SE Regulation).

[704] Articles 27(2) and 10(2) of Directive 77/91/EEC (Second Company Law Directive).

[705] Directive 2006/68/EC amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital.

[706] Article 1(2) of Directive 2006/68/EC inserting new Articles 10a and 10b.

[707] Article 10a of Directive 77/91/EEC (Second Company Law Directive), inserted by Article 1(2) of Directive 2006/68/EC.

nominal value or, where there is no nominal value, the accountable par and, where appropriate, to the premium on the shares to be issued for such consideration; (d) a statement that no new qualifying circumstances with regard to the original valuation have occurred."[708]

The Directive on takeover bids does not require the publication of external fairness opinions or independent advice in the context of share exchange offers. The Directive on takeover bids only requires the publication of an offer document which reflects the opinion of the offeror's board,[709] and the opinion of the offeree's board.[710]

However, such a requirement can be based on the rules applicable in a Member State.[711] In some countries the publication of fairness opinions or independent advice is mandatory.

For example in England, Rule 3 of the City Code on Takeovers and Mergers (Takeover Code) requires the board of the offeree company to obtain "competent independent advice" on any offer and to make the substance of such advice known to the company's shareholders (Rule 3.1). Sometimes the board of the offeror company has a similar duty (Rule 3.2). In France, Chapters I and II of Title VI (Book II) of the General Regulation of the Autorité des marches financiers (AMF) provides for independent appraisers and appraisals.

In many countries, external fairness opinions or the publication of independent advice may be part of commercial practice, a way to signal the benefits of the board's proposal to shareholders, and a way to mitigate the personal liability of board members.

Requirements as to the substance of the opinion or independent advice can reflect the choice of principal and agent in the legal framework. (a) In England, "advice should be as to whether or not the making of the offer is in the interests of the company's shareholders".[712] Shareholders are thus regarded as the principal and the board is regarded as their agent. This raises two problems. The first problem is that real shareholders have different interests, their real interests may conflict with those of the firm, and fictive shareholders do not exist. The second problem is that the most important principal of the board of a limited-liability company should be the firm itself (see Volume I and section 17.2). (b) The Directive on takeover bids nevertheless requires that "the board of an offeree company must act in the interests of the company as a whole".[713] A real shareholder may or may not benefit from decisions that are in the interests of the company as a whole. Whether fictive shareholders benefit from those decisions depends on what interests they are supposed to have. In any case, as shareholders are free to sell their shares, the firm re-

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[708] Article 10b(1) of Directive 77/91/EEC (Second Company Law Directive), inserted by Article 1(2) of Directive 2006/68/EC.
[709] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).
[710] Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).
[711] Article 3(2) of Directive 2004/25/EC (Directive on takeover bids).
[712] City Code on Takeovers and Mergers, Notes on Rule 3.2.
[713] Article 3(1)(c) of Directive 2004/25/EC (Directive on takeover bids).

lies on its shareholders as agents to decide on the acceptance of the offer and changes in its share ownership structure.[714]

5.12 Shares as a Means to Purchase Other Goods

Shares can be used as a means to fund the purchase of other goods. Usually, the firm issues shares to fund long-term capital investments such as the purchase of real estate or a business enterprise. In an "asset deal", the firm can pay for the purchase of a business enterprise by issuing shares to the company that sells the business.

Particular legal risks. For the firm, the use of shares as a means of payment gives rise to particular legal risks (for general risks, see section 1.4 above). In the EU, those risks are primarily caused by the legal capital regime.

Time. There is the question of time. The issuing of shares may require the prior consent of the general meeting. The internal decision-making of the company will be faster, if the board is authorised to decide on the matter. In many companies, it is standard practice that the annual general meeting passes a resolution authorising the board to decide on the issuing of shares and the waiving of shareholders' preemption rights.[715]

Valuation of assets. The value of goods bought by the firm may be too low. In Europe, the company must decide on the price payable for the shares.[716] (a) It can be argued that the price payable for the shares must be justified and not below their market value.[717] (b) If the value of the goods is lower than the price payable for the shares, negative consequences can follow depending on the governing law. *English* company law provides that "the allottee is liable to pay the company an amount equal to the amount of the discount, with interest at the appropriate rate";[718] this duty can be modified if it is "just and equitable to do so".[719] In *Germany*, however, the contract for the sale of those goods to the company would not be binding and the allottee would have to pay the price payable for the shares in cash.[720]

Form. There are requirements as to form. In particular, the Second Company Law Directive normally requires the drawing up of a report by "one or more independent experts appointed or approved by an administrative or judicial authority"[721] or at least "a fair value opinion by a recognised independent expert" or "a

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[714] Article 3(1) of Directive 2004/25/EC (Directive on takeover bids).
[715] Article 25(2) of Directive 77/91/EEC (Second Company Law Directive).
[716] Article 8(1) of Directive 77/91/EEC (Second Company Law Directive).
[717] Article 29(4) of Directive 77/91/EEC (Second Company Law Directive). See Case C-338/06, Commission v Spain, OJ C 261 of 28.10.2006 p 12 (application).
[718] Section 580(2) of the Companies Act 2006.
[719] Section 589(3) of the Companies Act 2006.
[720] § 27(3) AktG.
[721] Articles 10(1) and 27(2) of Directive 77/91/EEC (Second Company Law Directive).

declaration".[722] Depending on the choices of the Member State, there can be three important exemptions from the general requiring non-cash consideration for the shares of a public limited-liability company to be independently valued. These are the takeover exemption, the merger exemption,[723] and all shareholders' consent.[724]

Interpretation. Sometimes it is a matter of interpretation whether the company must comply with such requirements as to form. It may be unclear whether the company is regarded to have issued shares other than for a cash consideration. (1) In order to prevent circumvention, company laws may look at substance rather than form.[725] A classic example of circumvention prohibited by company laws is when the allottee makes a cash payment to the issuer's bank account and the issuer immediately buys assets from the allottee with those monies. (2) Furthermore, there may be differences as to what is regarded as "consideration in cash" or "consideration other than in cash".

In *England*, consideration in cash means that the company should receive "money or money's worth",[726] because a cash consideration has been defined as "(a) cash received by the company, (b) a cheque received by the company in good faith that the directors have no reason for suspecting will not be paid, (c) a release of a liability of the company for a liquidated sum, (d) an undertaking to pay cash to the company at a future date, or payment by any other means giving rise to a present or future entitlement … to a payment, or credit equivalent to payment, in cash."[727] In contrast, *German* law would not recognise the issuer's own debts as "cash". The conversion of debts into shares would therefore require compliance with the same requirements as to form as the sale of capital goods for shares. This means that the issuer's own debts must be valued.[728]

Permitted assets. Some goods are not recognised as suitable consideration for shares according to the Second Directive. If the company issues shares for a consideration other than in cash and the subscribed capital is increased, the consideration must consist of assets capable of economic assessment. An undertaking to perform work or supply services may not form part of those assets.[729]

For example, a listed telecommunications provider might want to engage a consultancy firm to assist in the development of corporate strategy. According to the wording of the

[722] Articles 10a(2) and 10b(1) of Directive 77/91/EEC (Second Company Law Directive), inserted by Article 1(2) of Directive 2006/68/EC.

[723] Article 27(3) of Directive 77/91/EEC (Second Company Law Directive).

[724] Article 27(4) of Directive 77/91/EEC (Second Company Law Directive).

[725] In Germany, "der wirtschaftlich einheitliche Vorgang". See Hüffer U, AktG (2002) § 27 number 15: "Schwierig bleibt die Abgrenzung gegenüber bloßen Verwendungsverbindungen, also Abreden über Mittelverwendung, die sich nicht als Rückführung von Geldeinlagen darstellen ..."

[726] Section 589(5)(a) of the Companies Act 2006.

[727] Section 583(3) of the Companies Act 2006.

[728] Hüffer U, AktG (2002) § 27 number 25: "Die Probleme liegen nicht in der Einlagefähigkeit, sondern der Bewertung." "Werthaltig ist die Forderung nur insoweit, als die AG imstande wäre, sie ohne Kapitalerhöhung zu bezahlen …"

[729] Article 7 of Directive 77/91/EEC (Second Company Law Directive).

Second Directive, no part of the remuneration of the consultancy firm may consist of shares allotted to it, if the subscribed capital is increased at the same time. The wording of the Directive does not prevent the allotment of shares to the consultancy firm, if the subscribed capital will not be increased. In practice, this is possible where the company's shares do not have a nominal value and the consultancy firm pays nothing for the shares; on the other hand, this would cause problems because of shareholders' pre-emptive rights (see above). The Directive does not say whether those rules can be circumvented by allotting share option rights instead of shares.

There are some exceptions. According to the Second Directive, Member States may "allow those who undertake to place shares in the exercise of their profession to pay less than the total price of the shares for which they subscribe in the course of this transaction".[730]

Contract v company law. It can be difficult to combine the terms of the contract for the purchase of assets with mandatory provisions of company law.

When assets are traded for cash, each party plays a clear role: one party acts as the buyer and the other as the seller. When assets are traded for shares, that relationship is complemented by another relationship: the seller of assets acts as the buyer (subscriber) of shares and the company acts as the seller (issuer) of shares.

Now, the contract for the sale and purchase of assets is likely to contain clauses that are characteristic of that particular contract type, and the contract for the subscription of shares may contain clauses that are characteristic of business acquisition contracts.

Two particular problems arise. First, the conclusion of those contracts may require compliance with detailed rules on the internal decision-making of the company (for counterparty corporate risk, see Volume II).[731] In practice, the contract for the sale of assets will often be conditional and subject to approval by the general meeting if the transaction should, according to the applicable company law rules, be decided on by the general meeting.

Second, usual remedies for breach of contract can be constrained by mandatory provisions of company law. For example, the seller of assets might not be able to repudiate the contract in the event of breach by the company of its representations and warranties or claim reimbursement of damage caused by the company breaching its contractual obligations, as distributions to shareholders are constrained by mandatory provisions of company law (see also section 16.4).[732]

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[730] Article 8(2) of Directive 77/91/EEC (Second Company Law Directive). For other exceptions relating to placements, see Article 3(2) of Directive 2003/71/EC (Prospectus Directive) and Articles 2(12) and 11 of Regulation 2273/2003.

[731] See nevertheless Article 9 of Directive 68/151/EEC (First Company Law Directive)

[732] Article 15(1)(c) of Directive 77/91/EEC (Second Company Law Directive).

5.13 Share-based Executive Incentive Programmes

Shares can form part of executive or employee incentive programmes. This raises traditional company law questions and questions relating to corporate governance (as well as questions of accounting and tax, which will not be discussed in this book). These questions have already been discussed in Volume I. Some comments can nevertheless be made.

Pre-emption rights. Beneficiaries of an incentive programme may be given a right to subscribe for new shares.

The use of share-based incentives is constrained by existing shareholders' pre-emption rights.[733] Pre-emption rights may be waived by decision of the general meeting. In that case, the administrative or management body must present the general meeting "a written report indicating the reasons for restriction or withdrawal of the right of pre-emption, and justifying the proposed issue price".[734] The general meeting may authorise another company body to decide on the share issue and the withdrawal of pre-emption rights within certain limits.[735] In practice, this is often done, and the board of a listed company will often be more or less automatically authorised to decide on share-based executive and employee incentive programmes.

Buy-back programmes, financial assistance. Beneficiaries of an incentive programme can also be given a right to buy or receive existing shares. EU company law makes it easier for the company to acquire shares that will be distributed to its employees and advance funds to employees who want to buy its shares.[736]

Synthetic options. Alternatively, the company can use synthetic options. From a legal perspective, it is easier for the company to decide on synthetic options, because the use of synthetic options is not constrained by the legal capital regime to the same extent.

Recipients of share-based incentives. As a rule, Community law does not limit the recipients of share-based incentives. There may nevertheless be sector-specific restrictions such as rules on the remuneration and integrity of statutory auditors under the Directive on statutory audits (see Volume I). In Germany, share options may not be granted to supervisory board members, because the supervisory board is not a management organ.[737] The same principle was adopted by the Commission in a non-binding April 2009 Recommendation[738] according to which remuneration for non-executive or supervisory directors should not include share options.

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[733] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).

[734] Article 29(3) of Directive 77/91/EEC (Second Company Law Directive).

[735] Article 29(5) of Directive 77/91/EEC (Second Company Law Directive).

[736] See Articles 19(3), 23(2) and 41(1) of Directive 77/91/EEC (Second Company Law Directive).

[737] § 192(2) AktG; BGH, judgment of 16.2.2004 - II ZR 316/02 (Mobilcom).

[738] Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, C(2009) 3177.

Size of share-based incentives. The size of share-based incentives is not directly constrained by the provisions of EU company and securities markets law, because core questions of corporate governance have not been harmonised in the EU. For example, it is a mandatory rule of the *German* Aktiengesetz that the remuneration of each management board member must be reasonable in light of the functions of the member in question and the situation of the company.[739] This is complemented by the recommendations of the German Corporate Governance Code.[740] *English* company law does not lay down any particular maximum amount of executive incentives. In April 2009, the *Commission* adopted non-binding Recommendations on remuneration policies. The Recommendations cover listed companies[741] and undertakings in the financial services sector.[742]

Disclosure of share-based incentives. Community institutions have also made attempts to enhance the transparency of remuneration policies and total remuneration paid. For this purpose, the Commission adopted a non-binding Recommendation on the remuneration of directors in October 2004.[743]

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[739] § 87(1) AktG.

[740] Section 4.2.2 of the German Corporate Governance Code. For the degree of compliance, see von Werder A, Talaulicar T, Kodex Report 2009: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex, Der Betrieb 2009 pp 689–696.

[741] Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, C(2009) 3177.

[742] Commission Recommendation on remuneration policies in the financial services sector, C(2009) 3159.

[743] Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/419/EC).

6 Mezzanine

6.1 Introduction

Mezzanine financing is regarded as a form of financing that contains elements of both equity and debt. From the perspective of the investor, typical mezzanine investments are subject to a higher risk than traditional debt instruments but to a lower risk than traditional shares. For this reason, mezzanine investors tend to require a higher return on their investment compared with holders of traditional debt instruments but may accept a lower return compared with holders of traditional shares. Typically, mezzanine instruments tend to resemble traditional debt instruments in that mezzanine capital will only be invested for a limited period of time and, in the insolvency of the company, repaid before shareholders' capital investment will be repaid.[1]

Sources of mezzanine financing. Mezzanine financing is often provided by credit institutions and specialist institutional mezzanine providers. There can be two or more layers of mezzanine debt.[2] Mezzanine capital is typically used: in the expansion phase of the firm; for large-scale investments; and in acquisitions and similar transactions involving a change in the ownership structure of the firm (spin-offs, MBOs/MBIs, pre-IPOs, trade sales).

Mezzanine instruments. Mezzanine instruments range from products that are issued to the public ("participation certificates", convertible bonds, bonds with options) to products that are placed privately (subordinated loans, "silent participations").

Mezzanine technique. Unlike "share capital" and "debt", "mezzanine financing" is not a normative concept. Mezzanine instruments are created by using the "mezzanine technique". Four things are characteristic of mezzanine instruments.

First, mezzanine instruments are *not recognised* as a particular class of contracts. A mezzanine instrument will therefore belong to another class of instruments, a class that is recognised at law. (a) From a legal perspective, a mezzanine instrument is usually a loan or a share, and a mezzanine investor will therefore be either a shareholder or a lender. In some countries, a mezzanine instrument can alternatively be a profit-sharing instrument that is neither a loan nor a share.

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[1] Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 5 number 9; Brokamp J, Ernst D, Hollasch K, Lehmann G, Weigel K, Mezzanine-Finanzierungen. Vahlen, München (2008) p 3.

[2] See Dyer R, Mezzanine Finance: Subordination and Priorities – an Overview, JIBL 5(4) (1990) pp 154–155.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
DOI 10.1007/ 978-3-642-03058-1_6, © Springer-Verlag Berlin Heidelberg 2010

(b) From an accounting perspective, a mezzanine instrument is regarded as a debt instrument or a share or a combination of both.

Second, if the instrument is *a debt instrument*, that instrument will be made to behave more like a share. For example, the debt instrument will be complemented with: the use of the equity technique (for the equity technique, see section 5.1); the choice of payment obligations that make the value of the instrument behave like the value of an equity instrument (for a taxonomy of payment obligations, see Volume II); the use of a right to an equity instrument (section 5.1); or a combination of two or more of those methods. In short, a typical mezzanine investment consists of a debt paired with an "equity kicker".

Mezzanine debts can thus be in the form of subordinated loans, second-lien loans, loans linked to an equity kicker, convertible bonds, or bonds with options.[3] They may also consist of a share seller's loans or shareholders' loans.

Mezzanine debt is usually unsecured. Alternatively, the debt is secured, but the collateral has a lower ranking (for second lien debt, see below) than the collateral of senior debt.

Third, if the instrument is *a share*, it will be made to behave more like a debt instrument. For example, such an instrument will be complemented with: an obligation to pay a fixed sum of money (Volume II); a right to repay or redeem the instrument; the use of credit enhancements (Volume II); or a combination of two or more of those methods.

Such mezzanine shares usually mean preferred shares (such as shares pursuant to § 139 AktG).

Fourth, in both cases, the *ancillary elements* of mezzanine financing would include: an average expected yield, lying between that of equity and debt capital; a limited term (usually five to ten years); and often tax deductibility of the costs associated with the provision of capital.[4]

Fifth, the laws of some countries may recognise profit-sharing arrangements that are *neither loans nor shares*. In Germany, such arrangements include silent partnerships or interests (see below).

Balance sheet. The categorisation of mezzanine capital on the balance sheet depends on the applicable accounting standards. For example, a German company might have to apply: German accounting standards set out in the HGB (if it is unlisted or listed on a market that is not a regulated market); international accounting regulations such as IAS/IFRS (if its securities have been admitted to trading on a regulater market in the EU); or US GAAP (if it is listed on a US stock exchange).[5]

Some mezzanine instruments are regarded as equity on the balance sheet of the company (equity mezzanine) and others are regarded as debt (debt mezzanine). There are also mezzanine instruments that, from an accounting perspective, con-

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3 Wiehe H, Jordans R, Roser E, Mezzanine Finance Structures under German Law, JIBLR 22(4) (2007) p 219; Habersack M, Grundfragen der freiwilligen oder erzwungenen Subordination von Gesellschafterkrediten, ZGR 2000 pp 384–419.

4 Wiehe H, Jordans R, Roser E, *ibid*, p 218.

5 See *ibid*, pp 221–222.

sist of an equity component and a debt component in the balance sheet (hybrid mezzanine). However, there is no mezzanine category according to IFRS. A mezzanine instrument is recognised as equity or as debt.

The categorisation on the balance sheet has an effect on the equity ratio and on the recognition of the paid costs. If the mezzanine capital is recognised as debt, any remuneration paid to holders of those mezzanine instruments will be an interest expenditure. If the mezzanine capital is recognised as equity, any remuneration will be a distribution of profits.

According to IAS/IFRS, the economic substance of the financial instrument is the main factor to be taken into account ("substance over form").[6] The fundamental principle of IAS 32 is that a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form (IAS 32.15).

A financial instrument is an equity instrument only if (a) the instrument includes no contractual obligation to deliver cash or another financial asset to another entity, and (b) if the instrument will or may be settled in the issuer's own equity instruments, it is either: a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments (IAS 32.16).

There are particular rules on compound financial instruments. Some financial instruments have both a liability and an equity component from the issuer's perspective. According to IFRS, the component parts must be accounted for and presented separately according to their substance based on the definitions of liability and equity (IAS 32.28). Convertible loans belong to this category.

Basel II. The recognition of an instrument as an equity capital instrument (Tier 1 capital), hybrid debt capital instrument (Tier 2 capital), or subordinated term debt instrument (Tier 2 capital) can help a bank to increase its capital base for regulatory purposes (see also section 5.1).[7] There can be Tier 3 capital in some jurisdictions. Tier 2 and Tier 3 capital instruments are mezzanine instruments.

Of the mezzanine instruments that can be recognised as capital, the recognition of hybrid debt capital instruments as Tier 2 capital instruments is least problematic according to the Basel Committee on Banking Supervision.

The Basel II Accord states: "In this category fall a number of capital instruments which combine certain characteristics of equity and certain characteristics of debt. Each of these has particular features which can be considered to affect its quality as capital. It has been agreed that, where these instruments have close similarities to equity, in particular when they are able to support losses on an on-going basis without triggering liquidation, they

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[6] The relevant regulations for the recognition of equity and debt capital and for receipt of income from such capital are IAS 32 Financial Instruments: Disclosure and Presentation (revised 2003) for treatment in companies/issuers of the financial instruments and IAS 39 Financial Instruments: Recognition and Measurement (revised 2003) for treatment at the investor level.

[7] Paragraph 49(iii) of the Basel II Accord.

may be included in supplementary capital. In addition to perpetual preference shares carrying a cumulative fixed charge, the following instruments, for example, may qualify for inclusion: long-term preferred shares in Canada, titres participatifs and titres subordonnés à durée indéterminée in France, Genussscheine in Germany, perpetual debt instruments in the United Kingdom and mandatory convertible debt instruments in the United States …”[8]

The recognition of subordinated term debt instruments as Tier 2 capital instruments is more problematic.

This has also been stated in the Basel II Accord: “The Committee is agreed that subordinated term debt instruments have significant deficiencies as constituents of capital in view of their fixed maturity and inability to absorb losses except in a liquidation. These deficiencies justify an additional restriction on the amount of such debt capital which is eligible for inclusioin within the capital base. Consequently, it has been concluded that subordinated term debt instruments with a minimum original term to maturity of over five years may be included within the supplementary elements of capital, but only to a maximum of 50% of the core capital element and subject to adequate amortisation arrangements.”[9]

In exceptional cases and only where permitted by national regulatory capital rules, short-term subordinated debt instruments may be recognised as Tier 3 capital.

One can again cite the Basel II Accord: “The principal form of eligible capital to cover market risks consists of shareholders’ equity and retained earnings (Tier 1 capital) and supplementary capital (Tier 2 capital) as defined in paragraphs 49(i) to 49(xii). But banks may also, at the discretion of their national authority, employ a third tier of capital (Tier 3), consisting of short-term subordinated debt as defined in paragraph 49(xiv) below for the sole purpose of meeting a proportion of the capital requirements for market risks, subject to the following conditions …”[10]

Reasons to use mezzanine finance. A non-financial firm can use the mezzanine technique for various reasons.

The *availability* of funding can play a role. Sometimes it is used because there is not enough shareholders’ capital and senior debt available to cover the firm’s funding needs.[11] Mezzanine capital is often applied in the context of buy-outs and venture capital. It is suitable for so-called “pre-IPO bridge financing” as well as for rescue and restructuring of companies and for growth financing, acquisitions, leveraged buy-outs (LBOs) or management buy-outs (MBO) or buy-ins (MBIs). It is, however, not suitable for covering the ongoing financing needs of a company.[12]

Mezzanine instruments can match the *risk-reward preferences* of some investors. The issuing of a wider range of capital instruments may enable the firm to raise more funding and to reduce the overall cost of external funding.

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[8] Paragraph 49(xi) of the Basel II Accord.

[9] Paragraph 49(xii) of the Basel II Accord.

[10] Paragraph 49(xiii) of the Basel II Accord. For short-term subordinated debt eligible as Tier 3 capital, see paragraph 49(xiv) of the Basel II Accord.

[11] Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 4 number 7.

[12] Wiehe H, Jordans R, Roser E, Mezzanine Finance Structures under German Law, JIBLR 22(4) (2007) p 219.

Mezzanine funding can therefore be an important part of the firm's *funding mix*. In particular, subordination can make it easier to raise senior debt and reduce its cost. First, subordinated debt can act as a cushion in the event of insolvency. Second, subordinated debt can also be subscribed for by insiders in order to mitigate senior lenders' agency problems. For example, in project finance, the sponsors of the project sometimes subscribe for subordinated loan instruments issued by the project company. This may help: to manage the agency relationship between sponsors and external investors; to signal that the sponsors are committed to the project; to mitigate external investors' perceived risk exposure; and to raise funding and reduce its costs.

Mezzanine financing can work as a *functional equivalent* to shareholders' capital. At the same time, mezzanine instruments can be a way to raise funding without diluting the holdings of existing shareholders.

Some forms of mezzanine financing (such as Genussscheine, German participation certificates)[13] can be regarded as equity capital on the balance sheet of the company for *accounting purposes*. Some forms of mezzanine financing can be regarded as equity capital for the purposes of *company law* or *tax law*.

Mezzanine instruments can also be used because of their impact on the firm's *credit rating*. If the mezzanine instrument is recognised as an equity instrument for credit rating purposes, the issuing of mezzanine instruments is a way to improve the firm's rating and borrowing capacity.[14]

In addition, mezzanine loans issued by many debtors can be *securitised* and placed on the market by mezzanine providers. Mezzanine financing is thus a service product, and there is a market for securitised mezzanine loans.

A further reason to use mezzanine financing is *transfer of risk*. Risk can be transferred for the benefit of senior lenders. It is characteristic of mezzanine financing that junior lenders are exposed to a higher credit risk than senior lenders are. Risk can even be transferred for the benefit of the firm, if the firm can raise financing without obligation to repay it in times of financial stress.

Transfer of risk, destocking. The combination of a debt instrument and payment terms that make the value of the instrument track the value of equity instruments gives the firm a chance to transfer aggregated risks to those who invest in mezzanine instruments.

As said above, mezzanine instruments can sometimes be used as a functional equivalent to equity. For example, shareholders' capital might be replaced by contracts that offer contingent claims or loan agreements with a variable interest rate and variable repayment schedule that depend on the outcome of certain events (for contingent claims, see Volume II). In such a case, there is a difference between a normal high-yielding debt instrument and the mezzanine instrument. Depending on the terms of the mezzanine instrument, its holders can take the first hit and their chances to receive payment may be completely wiped out if a certain event occurs.

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[13] § 221(3) and § 221(4) AktG.

[14] Wiehe H, Jordans R, Roser E, *op cit*, pp 222–223.

At the same time, holders of normal high-yielding debt instruments might still receive payment.[15]

Whether the mezzanine investors will really take the first hit can depend on the interests of the firm. Failure to pay can signal higher risk and increase funding costs in the future.

Issuer's exposure to legal risks. In addition to the general risks related to all forms of funding, recharacterisation and derecognition are particular legal risks inherent in mezzanine financing. Recharacterisation and derecognition are events that usually trigger an event of default under the terms of the contract (section 4.3).

Where the firm issues mezzanine instruments to increase the amount of equity in the balance sheet, recharacterisation risk means that the mezzanine instrument might not be recognised as an equity instrument (for recognition and derecognition, see section 3.3.2).

Even mezzanine investors can be exposed to a recharacterisation risk. In addition to changes in the tax treatment of the investment, there can be company law risks. Depending on the law governing the company and the law governing insolvency proceedings, a loan might be recharacterised as equivalent to shareholders' capital in which case the repayment of the loan is subject to restrictions. The risk is increased when "downstream" loans are combined with share ownership, or when the company is controlled by the investor.

Under *German* law, the repayment of shareholder loans[16] is subject to restrictions. In addition, where the insolvency of the company has been caused by the transfer of funds to a shareholder, the shareholder may have to return the funds to the company.[17] These rules were introduced by the MoMiG and replaced the rules on equity-replacing loans ("eigenkapitalersetzendes Darlehen") applied when the company was in a crisis.[18] Rules on equity-replacing loans continue to apply in *Switzerland*.[19]

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[15] For the fate of holders of participation certificates issued by AHBR in Germany, see Welcome to the wild frontier, The Economist, July 2006.

[16] § 39(1) number 5 and § 135 InsO (Gesellschafterdarlehen) introduced by the MoMiG.

[17] § 826 BGB; see also § 64 GmbHG.

[18] § 32a GmbHG (now deleted). The company was in a crisis when: it was not able to borrow funds from third parties at market conditions; it was insolvent; or its debts exceeded its funds (Überschuldung). Since BGHZ 90, 381 ("BuM"), it was clear that similar rules could be applied to AGs by analogy. See Habersack M, Grundfragen der freiwilligen oder erzwungenen Subordination von Gesellschafterkrediten, ZGR 2000 pp 384–419; Blöse J, Cash-Management-Systeme als Problem des Eigenkapitalersatzes, GmbH-Rundschau 14/2002 pp 675–678; Cahn A, Kapitalaufbringung im Cash Pool, ZHR 166 (2002) p 281; Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 38 number 18.

[19] Obergericht des Kantons Zürich, judgment of 19 January 1993; BGE, judgment of 2 March 2006, 5C.230/2005. For an introduction, see Stöckli U, Das kapitalersetzende Darlehen im Konkurs einer Aktiengesellschaft, Der Schweizer Treuhänder 2007/9 pp 662–666; Groner R, Private Equity – Recht. Stämpfli Verlag AG, Bern (2007) pp 126–127. See also Barthold BM, Mezzanine-Finanzierung von Unternehmensübernahmen, SZW/RSDA 5/2000 p 232.

6.2 Example: Venture Capital Transactions

The use of mezzanine instruments can be illustrated by venture capital. Venture capital is often used where an entrepreneur wants to raise external funding for the purpose of financing further growth or in the context of a management buy-out (MBO) or buy-in (MBI). Venture capital investors will look for an exit within the next three to five years. This may be by an IPO, a trade sale, refinancing by another institution, or a repurchasing of the entire capital by management. A venture capital investor can provide a mixture of debt, equity and mezzanine financing.[20]

Table 6.1 Venture Capital and Private Equity

Venture capital				Private equity	
Seed	Start-up, early stage	First expansion	Later expansion	Spin-off, MBO/MBI	Pre-IPO, trade sale
Loss stage				Profit stage	

Process. There is a lengthy process before the firm can raise venture capital from the market. Usually, the process takes some months. The screening of proposals is intense, and only a tiny fraction of proposals will pass the test. From the perspective of the venture capitalist, the process could be as follows:

Table 6.2 The Process of Venture Capital Talks

Establishing contact	Preliminary analysis	Due diligence	Negotiations	
Initial discussions. Confidentiality agreement. Presentation of the firm and its management. Visits to the firm.	Review of the firm's business plan and corporate strategy. Rating based on the last three financial years. Market analysis. Indicative offer. Preparation and signing of a Term-sheet.	Detailed analysis (technical, financial, tax, legal). Verification of information disclosed by the firm.	Drafting of contract documents. Final negotiations. Signing. Closing.	Completion.

Structure. Venture capitalists devote much attention to the structure of the deals, and conditions imposed on firms are drastic. Venture capital deals usually include:[21]

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[20] Weitnauer W, Kuhmann T, Meier HM, in: Weitnauer W (ed), Handbuch Venture Capital, 2. Auflage. C.H. Beck, München (2001) C 4; von Salis-Lütolf U, Risiko- und Gewinnverteilung bei privaten Finanzierungen, SJZ 97 (2001) pp 213–224; Groner R, Private Equity – Recht. Stämpfli Verlag AG, Bern (2007) pp 1–14.

[21] See Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) pp 90–91.

- Stages. There is a detailed outline of the various stages of financing (like seed investment, prototype testing, early development, growth stage, and so forth). At each stage the firm is given just enough cash to reach the next stage.
- Unilateral exit. The venture capitalist reserves the right to stop funding unilaterally at any stage. Sometimes the venture capitalist may have a right to demand repayment of all or some of the already invested capital. Debt instruments can be used for this purpose.
- Regular exit. The venture capitalist wants to benefit from an increase in the value of the firm. This requires ownership of shares that can be sold to other investors.
- Anti-dilution. Pre-emptive rights and other anti-dilution mechanisms enable venture capitalists to control new financing.
- Preference shares and conversion rights. Preference shares will be senior to the entrepreneurs' ordinary shares in liquidation. The right to convert preference shares or convertible loans to common shares enables the venture capitalist to obtain control and fire managers if some key investment objective is not met or to benefit from an increase in the value of the firm. Making control rights contingent enhances managerial incentives and boosts borrowing capacity.[22]
- Non-competition clauses. Non-competition clauses for the entrepreneur and key managers and employees are designed to reduce commercial risk (section 16.3).

Shares. A venture capital firm invests primarily in shares because this will enable the venture capital firm to profit from the success of the venture. The venture capital firm can mitigate commercial risk by subscribing for preference shares that ensure that the venture capital firm gets a priority call on the profits of the company in the form of dividends; those preference shares may further be convertible into common shares.

The problem of dilution. The issuing of new shares will raise the question of dilution. Any new claimant to the assets and/or income of the firm reduces the percentage interests of existing claimants. If A owns 100% of shares and B purchases newly issued shares that will represent 25% of all shares, A's share of claims on the firm's future income is diluted. On the other hand, B might contribute assets that enable the firm to increase its future income by 50%. In that case, the income that will actually be distributed to A may increase.

Typically, existing shareholders try to keep as much of voting rights as possible. New investors try to prevent the dilution of their holdings when the firm issues new shares in the context of later financing rounds.

Most venture capital financings include anti-dilution provisions that protect financial investors. Purchasers of shares in venture financings look for protection against subsequent share offerings at lower prices, as well as structural protection against changes in the corporate structure.

[22] Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 394.

Investors can achieve anti-dilution protection in many ways. (a) There is no standard anti-dilution protection. There are nevertheless some general models used by venture capital firms. (b) Anti-dilution price protection can be a formula which is applied to determine the number of shares issued upon a conversion. If the company has issued convertible bonds or convertible shares, the conversion terms can depend on the terms offered to new investors. If the company subsequently issues securities at a price lower than that paid by the investor, more shares will be issued upon conversion of the convertible bonds or convertible shares. Price-based antidilution protection is thus accomplished by changing the conversion ratio and by increasing the rate at which previously issued bonds or preference shares are converted into common shares. (c) Anti-dilution price protection can become important, for example, after a negative change in the valuations of companies. The two most popular methods are called weighted average and full ratchet.

The firm can try to dilute the terms of anti-dilution protection. (a) For example, the firm can agree that the anti-dilution provisions: only apply for a certain period of time; do not apply when shares are issued in transactions that are approved in a specific manner (for example, by a majority of the class of financial investor protected by the term); and do not apply when shares are issues for fair value. (b) Most agreements relating to venture capital transactions contain provisions that permit the amendment of the venture capital agreements and the articles of association of the company with the consent of the company's board and a specified qualified majority of the investors' votes. The purpose of such provisions is to allow changes in the documentation to be effected even if a minority of the investors object. A large investor would therefore ensure that it has a share block that gives it enough votes to block any changes in the articles of association.

Loans. The venture capital firm can also lend money to the company. The benefit of debt is that it is repayable if the venture fails. The venture capital firm can mitigate agency problems and increase potential return through convertibility. On the other hand, the downside of debt is that the mere repayment of capital does not enable the lender to profit from the success of the venture.

Equity kicker. This problem can be cured by using an equity kicker (see also sections 6.3.8 and 20.7). For example, the venture capital firm can subscribe for a convertible loan or be given share option rights. If the loan is a convertible loan, the venture capital firm can: obtain control of the company when it turns out that the company's owner-managers do not perform as agreed; or increase profits when it turns out that the venture is successful. The same objectives can alternatively be achieved through share options.

There are alternatives to the equity kicker. For example, the parties may agree on so-called tag-along rights of the venture capital firm in order to ensure that the venture capital firm will be entitled to a share of the price paid for the company's shares when they are sold.

6.3 Loan-based Mezzanine Instruments

6.3.1 General Remarks

It is characteristic of loan-based mezzanine instruments that they are subordinated. Subordination means an arrangement where one lender or group of lenders agrees not to be paid by a borrower until another lender or group of lenders creditors have been paid. In addition, mezzanine instruments may entitle their holder to participate in the profits of the issuer. This will often be achieved by means of an equity kicker. Subordination can be structural, or it can be based on different repayment schedules, statutory subordination, or contractual subordination.

Payment waterfalls. In addition to subordination compared with traditional (senior) loans, there can also be contractual "payment waterfalls" that create subordination between different holders of mezzanine instruments under the terms of an intercreditor agreement.

Covenants and prepayment. As loan-based mezzanine instruments typically rank junior to senior loans, the covenants typically cannot be more restrictive than those used in senior loan facilities. The same principles apply to sanctions triggered by an event of default.

For example, although the same kinds of financial covenants can be used both in senior loan facilities and mezzanine loan facilities, the parties usually agree that breach of a financial covenant under the mezzanine loan facility will not trigger any right to terminate the mezzanine loan unless the circumstances are such that they already have triggered senior creditors' right to terminate senior loans. In addition, there may be a long grace period – for example, 120 days – before any right to terminate the mezzanine loan is triggered.[23]

IFRS. Whether loan-based mezzanine instruments are regarded as equity instruments or debt instruments depends on:[24] whether investors have a right to terminate the investment;[25] whether there is a fixed maturity;[26] whether distributions are in the discretion of the issuer;[27] whether the issuer has discretion to terminate the investment;[28] and whether payment obligations are triggered by external events or insolvency.[29]

[23] Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 38 number 19.
[24] Kraft ET, Die Abgrenzung von Eigen- und Fremdkapital nach IFRS, ZGR 2–3/2008 p 353.
[25] IAS 32.18(b).
[26] IAS 32.16.
[27] IAS 32.17.
[28] IAS 32.20.
[29] IAS 32.25.

6.3.2 Structural Subordination of Debts

There is a distinction between subordination of debts and structural subordination. Structural subordination typically arises where the main assets of a group are owned by one or more subsidiaries, but the borrowing is undertaken by the parent company.[30]

Structural subordination is based on the fact that distributions by a company to its shareholders are constrained by company law rules and require the availability of distributable assets.[31] The debts of an operating company in which the assets are usually invested are therefore structurally more senior than the debts of its holding company. In other words, creditors of the holding company (junior creditors) effectively rank behind creditors of the operating company (senior creditors) because they are creditors of a shareholder rather than creditors of the company that owns the assets.[32]

The parties may create structural subordination through holding companies and debt push-up.[33] The use of holding companies as debtors will increase structural subordination. Debt push-up means that the debt is assigned to the parent company of the debtor. The assignment of a debt normally requires the prior consent of the creditor and the consent of the security giver (such as a guarantor or owner of collateral).[34]

The parties may reduce structural subordination through the assignment of the holding company's debts to its operating subsidiary.[35] This may nevertheless be constrained by company laws. Depending on the jurisdiction, the assignment of a shareholder's debts to the (subsidiary) company can be regarded as distribution of assets to a shareholder, or be contrary to the principle of the equivalent treatment of shareholders. Furthermore, the assignment of debts can be constrained by the general purpose and stated objects of the subsidiary.[36]

6.3.3 Repayment Schedules as a Form of Subordination

There is a distinction between subordination and the use of different repayment schedules. In a loan transaction, the mezzanine effect can generally be achieved through the equity technique. For example, the use of different repayment schedules can help to create senior term loans, junior term loans, and mezzanine debt.

It is characteristic of senior term loans that they have the shortest maturity and will be repaid in regular instalments over the term of the loan.[37] The junior tranche can have a longer maturity than the senior tranche and be repaid in fewer instal-

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30 Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006) paragraph 8.3.
31 Article 15(1)(a) of Directive 77/91/EEC (Second Company Law Directive).
32 Diem A, *op cit*, § 39 number 4.
33 *Ibid*, § 39 numbers 5–6.
34 For German law, see §§ 418, 182(2) and 766 BGB.
35 Diem A, *op cit*, § 39 number 7.
36 See, for example, Article 9(1) of Directive 68/151/EEC (First Company Law Directive).
37 Diem A, *op cit*, § 5 number 6.

ments. For example, the whole capital amount can be repaid at the end of the term of the loan (bullet repayment) or in two instalments after the senior tranche has already been repaid.[38] Mezzanine loans can be repaid after all senior debt has been repaid.[39]

The main rule is that the ranking of loans in insolvency is not influenced by their repayment schedules. In the absence of a contract or a statute, the main rule is that the debts will rank pari passu.

6.3.4 Statutory Subordination

There are statutory exceptions to the pari passu principle. Claims can be deferred by statute below the claims of other creditors in many ways. For the ranking of claims in insolvency in general, see Volume II.[40] Of particular interest in this context can be the potential existence of mandatory provisions subordinating the debtor's loans from shareholders or its loans from banks that have legal or de facto power to control the debtor company (see Volume II).[41]

6.3.5 Contractual Subordination of Debts

Contractual subordination enforceable when the debtor becomes insolvent is one of the most common equity techniques (see above) and subordinated loans are the most common form of mezzanine instruments. Subordinated debt is also known as "junior debt".

Contractual subordination is a contractual exception to the pari passu principle. Contracting out of the pari passu principle can be allowed on the basis that a creditor would be permitted to waive a debt in full (or in part) and that this might be agreed ex ante or ex post.[42]

Subordinated loans are usually only granted if the lender believes that the borrower can repay them out of cash flow. Subordinated loans are a form of middle-

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[38] *Ibid*, § 5 number 7 and § 38 number 2.

[39] *Ibid*, § 39 number 1.

[40] For German law, see § 39(1) InsO and Diem A, *op cit*, § 39 numbers 8–10. For English law, see, for example, section 215(4) of the Insolvency Act 1986 and Soden v British & Commonwealth Holdings plc (in administration) [1997] UKHL 41, [1997] 4 All ER 353, [1997] 3 WLR 840, [1998] AC 298. See also Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006) paragraph 8.2: "There are many ways in which one creditor of an English company can rank junior to another in an insolvent winding up: unsecured creditors rank junior to secured and preferential creditors; floating chargees rank junior to fixed chargees and preferential creditors; preferential creditors rank junior to fixed chargees; and one fixed chargee may rank junior to another."

[41] See Habersack M, Grundfragen der freiwilligen oder erzwungenen Subordination von Gesellschafterkrediten, ZGR 2000 pp 384–419; Schall A, Kapitalaufbringung nach dem MoMiG, ZGR 2009 pp 126–155; the MoMiG; and § 19 GmbHG.

[42] For English law, see Re Maxwell Communications Corporation plc (No. 2) [1994] 1 All ER 737; Finch V, Corporate Insolvency Law. Cam U P, Cambridge (2002) p 443.

term or long-term financing. Lenders usually require covenants (for covenants, see Volume II).[43]

The lender is remunerated in three ways: by means of fixed payments, variable payments, and a kicker. Higher risk normally means an above-average interest rate. There can be a combination of regular interest payments and interest payable upon the maturity of the loan. A subordinated loan can have a variable or fixed interest rate, and a combination of profit-related and profit-unrelated interest (equity kicker).[44]

In Germany, a subordinated loan is legally a normal loan under the German Civil Code (BGB).[45] In principle, the above-average interest rate payable for subordinated loans could be regarded as unethical ("sittenwidrig" under § 138 BGB). In practice, however, this is unlikely because of the substantial risk to which the mezzanine lender is exposed.[46]

Reasons to use contractual subordination. Subordination may be useful in a number of circumstances.

Subordination of debts enables a bank to increase its capital base for regulatory purposes. Subordinated debts can be categorised as supplementary capital (Tier 2 or Tier 3) under the Basel II framework.[47].

According to *Finch,* the most important reasons to use subordinated loans include the following: "to allow shareholders or directors to inject funds into a company where existing creditors will not allow further unsubordinated borrowings; to allow parent companies to enhance the credit of a subsidiary that is issuing securities (so that an appropriate rating for the securities will be obtained); to allow companies to appeal to investors who seek high incomes in return for higher risk bearing; and to allow a bank to issue funds for treatment as capital for capital adequacy purposes".[48]

Bilateral contract. There is no one way to subordinate claims. Subordination requires a contract. Where the debtor and a mezzanine lender agree on the subordination of a debt, that agreement is binding between those two parties. However, it would not necessarily confer any rights on other lenders (senior lenders), and senior lenders prefer subordination agreements that they can enforce themselves.

Intercreditor agreement. To put senior lenders in such a position, it is necessary for mezzanine lenders to give covenants directly in favour of the senior lenders. This can be achieved either by the senior lenders themselves being a party to the mezzanine debt documents, which is fairly rare, or by the senior lenders and the mezzanine lenders being a party to an intercreditor agreement, regulating the en-

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[43] Wiehe H, Jordans R, Roser E, Mezzanine Finance Structures under German Law, JIBLR 22(4) (2007) p 219.

[44] *Ibid*, p 219.

[45] § 488 BGB.

[46] Wiehe H, Jordans R, Roser E, *op cit*, pp 219.

[47] Paragraph 49(iv) of the Basel II Accord.

[48] Finch V, Corporate Insolvency Law. Cam U P, Cambridge (2002) p 444, citing Ferran E, Recent Developments in Unsecured Debt Subordination. In: Rider (ed), The Realm of Company Law. Kluwer, London (1998) pp 199–215 at p 201.

tire position as between the two sets of creditors, but conferring no priority as against third parties. This contract should generally be effective prior to a liquidation of the borrower.[49]

The intercreditor agreement will typically be signed by the borrower, the senior lenders, the mezzanine lenders, the agent of the senior lenders, the agent of the mezzanine lenders, and the security agent. It can also be signed by equity investors such as the shareholders of the borrower.[50]

Insolvency. In the insolvency of the borrower, the main rule is that the borrower's insolvency administrator will apply the pari passu principle. It is nevertheless possible to contract out of pari passu.

Under *German* law, the insolvency administrator will be bound by a multilateral agreement between senior lenders, junior lenders and the debtor. The insolvency administrator will not be bound by a bilateral agreement between senior lenders and junior lenders as the debtor is not a party.[51] The insolvency administrator will nevertheless be bound by an agreement between the debtor and a creditor according to which the claims of the creditor will rank behind all other debts.[52]

Where the liquidation of a company is governed by *English* law, the main rule is that a subordination agreement does not bind the liquidator to pay out in a non-pari passu way.[53] It is a fundamental principle of English insolvency law that the assets of an insolvent company which have not been the subject of any valid security and which are not required to pay off claims preferred by statute should be available for the discharge of the claims of unsecured creditors on an equitable, that is, pari passu, basis. This rule of public policy was confirmed by the House of Lords in *British Eagle v Air France*.[54] However, contracting out of pari passu on subordination was permitted in the *Maxwell Communications* case, because there were no good public policy reasons for the pari passu rule to be mandatory.[55] Prior to Maxwell, two methods were in use for effecting subordination without infringing the principle of pari passu treatment: trust subordination and contingent debt subordination.[56]

Terms of intercreditor arrangements. Intercreditor arrangements between senior lenders and mezzanine lenders will often cover the following issues:[57]

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[49] Diem A, o*p cit*, § 39 numbers 11–13; Dyer R, Mezzanine Finance: Subordination and Priorities – an Overview, JIBL 5(4) (1990) pp 155–158.

[50] Diem A, *op cit*, § 40 numbers 1–2.

[51] Diem A, *op cit*, § 40 number 13.

[52] §§ 39(2) and 80(1) InsO (Rangrücktrittsvereinbarung). Diem A, *op cit*, § 40 number 17.

[53] Section 107 of the Insolvency Act 1986 and rule 4.181 of the Insolvency Rules 1986.

[54] Lord Cross in British Eagle v Air France [1975] 1 WLR 780.

[55] Re Maxwell Communications Corporation plc (No. 2) [1994] 1 All ER 737. See Finch V, Corporate Insolvency Law. Cam U P, Cambridge (2002) pp 443–444; Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006) paragraphs 8.6–8.11.

[56] See Fuller G, *op cit*, paragraphs 8.11–8.17.

[57] Bohrer A, Corporate Governance and Capital Market Transactions in Switzerland. Schulthess, Zürich Basel Genf (2005) pp 203–204.

- stand still-period (where senior lenders have called an event of default, mezzanine lenders are bound by a period of, say, 90 days before they can call an event of default based on the mezzanine financing documents);
- use of proceeds (surplus revenues such as proceeds from sales or insurance payments must be allocated between the parties);
- amendments to facility documents (they are usually subject to restrictions in order to prevent circumvention of the inter-creditor arrangements);
- default provisions (mezzanine investors want to prevent senior lenders from calling events of default for minor breaches);
- take-out options (repayments of senior debt may trigger the right of mezzanine lenders to buy the senior debt); and
- priority ranking (security granted to senior lenders will rank prior to any security granted to mezzanine investors).

Conflicting interests. Generally, senior lenders and mezzanine lenders can have conflicting interests.

Senior lenders generally want to ensure: that mezzanine loans are as close to share capital as possible; that senior lenders receive all their principal and interest before mezzanine lenders get any principal (and, if possible, interest); and that senior lenders have maximum flexibility to agree changes to the senior debt with the borrower. For example, they want the mezzanine loan to be subordinated to any current or future finance which they advance and the mezzanine lenders to have minimal rights to call the mezzanine loan in default and trigger bankruptcy.[58]

In addition, senior lenders want to prevent certain things from happening: that the arrangements can be modified without their consent;[59] that junior lenders may assign their claims or dispose of them otherwise before senior debt has been repaid in full;[60] and that the debtor may set off its claims against the claims of junior lenders.[61]

Junior lenders (mezzanine lenders) generally may want to: keep the difference between senior debt and mezzanine debt small; minimise the extent to which senior lenders may increase the risk to which mezzanine lenders are exposed; restrict the definition of senior debt to a maximum amount; and restrict amendments to the terms of the senior debt.[62]

The parties will need to address, for example, the following questions when subordinating debts:[63] What rights are to be subordinated? Which loans and lenders are to have the benefit of the subordination? Is the subordination a complete subordination (the debt is subordinated to all other present or future indebtedness of the borrower and its subsidiaries) or a 'limited inchoate' subordination (the debt

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58 Dyer R, Mezzanine Finance: Subordination and Priorities – an Overview, JIBL 5(4) (1990) pp 154–155.
59 Fuller G, *op cit*, paragraph 8.19.
60 Diem A, *op cit*, § 39 number 14.
61 Diem A, *op cit*, § 39 number 15; See Fuller G, *op cit*, paragraph 8.24.
62 Dyer R, *op cit*, pp 154–155.
63 *Ibid*, pp 154–155.

is a second ranking secured debt coming behind a specified amount of senior debt)? Subordination will usually not apply to the payment of interest.[64] Should subordination be limited to repayment of principal (and are senior lenders to get all their principal before mezzanine lenders get any) or should the mezzanine lenders' rights to interest also be subordinated? Should the senior lenders get all their principal and interest before the mezzanine gets any interest or, as is more usual, should interest on the mezzanine only be subordinated while the senior loan is in default? For how long is the subordination to last?[65]

6.3.6 Contractual Subordination of Collateral

Normally, what is subordinated is debt, and the subordinated mezzanine debt is secured by the same collateral as senior debts. The intercreditor agreement will then provide that senior debt will be repaid before mezzanine debt.[66] Alternatively, the parties may "subordinate" collateral rather than debt. For example, the parties can use second lien financing as an alternative to subordinated debt.[67] In principle, the parties can agree to subordinate either the debt or the collateral or both.

Investor preferences. Sometimes the subordination of collateral can increase investor demand. As said above, mezzanine loan instruments are always subordinated pursuant to the intercreditor agreement and, in many cases, even structurally subordinated. This can create a problem for some fund investors, if their investment parameters require them to buy only senior debt instruments (rather than subordinated mezzanine loan instruments). Subordinating collateral can help to solve this problem.

For example, the borrower has two loan facilities, A and B. Claims under the A facility are unsubordinated (senior). Claims under the B facility rank pari passu with claims under the A facility. The B facility instruments therefore rank as senior debt. If the security support provided for the B facility is subordinated to the security support provided for the A facility, the B facility instruments can still be said to rank as a senior debt. Through the second ranking security, the second lien B facility instruments rank ahead of unsecured debt (such as trade debt) and any structurally subordinated debt (for example, most high-yield or junk bonds).[68]

Second lien debt. Second lien debt is debt that benefits principally from the same security as secured senior debt, on a second ranking basis. Because of higher risk,

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[64] See Diem A, *op cit*, § 38 number 4: "Regelmäßig wird eine Sockelverzinsung aus dem anwendbaren Referenzzinssatz (EURIBOR, LIBOR) zuzüglich einer Marge vereinbart. Diese Zinsen sind jeweils spätestens am Ende einer Zinsperiode fällig und werden – trotz des Nachrangs – auch ausbezahlt."

[65] Dyer R, *op cit*, pp 154–155.

[66] Diem A, *op cit*, § 38 number 20 and § 40 number 9.

[67] See Wells C, Devaney N, Is the Future Secure for Second Lien Lenders in Europe, JIBLR 22(8) (2007) pp 443–447.

[68] See Sharples R, United Kingdom: How Europe is stretching debt packages, The IFLR guide to Mergers and Acquisitions 2005.

second lien debt is more expensive than senior bank debt. However, unsubordinated second lien debt is significantly less expensive than traditional subordinated debt. Furthermore, institutional investors and hedge funds that are unable to invest in contractually subordinated debt may invest in second lien debt as the lender is only subordinated on enforcement of security.

US practices, covenants, repayment rights. There have traditionally been differences between the US and Europe.[69] Second lien debt makes up a significant segment of the US capital markets.

In the US, second lien loans have been developed to appeal to US institutional investors that cannot participate in subordinated debt and are typically lent at the same level as a senior asset-based loan. They will usually contain the same covenants and repayment rights as the senior loans (although second lien bonds will have no maintenance covenants or cross-default provisions).[70]

European practices. Second lien debt is relatively new in Europe. With no harmonised European insolvency regime, there is currently no standard form for second lien financings.[71] In Europe, the overwhelming majority of second lien deals form part of refinancings or recapitalisations after an LBO (sections 10.5 and 20.5.3). Second lien issuance is increasingly being used to finance primary LBOs.[72]

Subordination terms. A second lien arrangement requires an agreement not only between the security giver and the lenders but also an agreement between the senior (first lien) lenders and second lien lenders. The senior (first lien) lenders and second lien lenders agree that on enforcement of the security, the senior lenders will be paid in full from the realisation proceeds before the second lien lenders receive anything.[73]

Typical second lien security subordination provisions will usually include undertakings from the second lien lenders: not to take enforcement action while senior secured debt is outstanding (permanently or for a limited period); not to challenge enforcement actions of senior security holders; not to challenge the validity or priority of senior security; to waive or limit (usually for a specified time) other typical secured creditors rights as regards the senior security holders (for example, whether and when to exercise remedies against the secured assets, the order in which to foreclose on which secured assets, the type of sale in which to sell secured assets, and the appropriate price for, and buyers of, secured assets); and/or automatic release of second lien security rights over any collateral upon a sale of that collateral pursuant to a senior security enforcement.[74]

[69] Wells C, Devaney N, *op cit*, p 445.
[70] *Ibid*, pp 443–447.
[71] See *ibid*, pp 446–447.
[72] *Ibid*, pp 443–447.
[73] *Ibid*, pp 443–447.
[74] Sharples R, United Kingdom: How Europe is stretching debt packages, The IFLR guide to Mergers and Acquisitions 2005.

6.3.7 Structural Subordination of Collateral

Like the subordination of debt, even the subordination of collateral can be structural. For example, a secured creditor can have a security interest at the asset level or the company level.

The former is a security interest in particular assets of the company. If the assets are sold to repay the secured debt, the main rule is that the holder of the security is entitled to the full value of the asset minus costs.

In contrast, the latter is a security interest in the company's shares. If those shares are sold to repay the secured debt, the security holder will be entitled to the value of those shares minus costs but not to the full value of the company's assets. The shares can be worth nothing.

A limited-liability company typically cannot give its own shares as collateral under the European legal capital regime but the shares can be given as collateral by a shareholder. As the collateral is not given by the company itself, it might not necessarily violate negative pledge clauses under that company's other financial contracts (but would force the shareholder to study its own obligations under its own financial contracts).

It is easier for a limited-liability company to give a subsidiary's shares as security for its own debts or – within the limits of the purpose of the company and any applicable particular restrictions (for acquisition finance, see section 20.4) – other debts.

A share sale under the terms of the security agreement is a relatively easy way to enforce a security. Unlike the sale of the company's assets, it would not influence the position of the company's unsecured (trade) creditors or its secured creditors who have a security interest in the company's assets.

6.3.8 Participation in Profits

The terms of the loan can provide that the lender's remuneration is at least partially profit-related. Although the remuneration depends on profits, the lender is not a shareholder. In the insolvency of the debtor, the lender is a simple creditor.[75]

Equity kicker. Profit-related remuneration can be in the form of an "equity kicker". Equity kickers can be real or synthetic.

A real equity kicker means a right to subscribe for shares. For example, the company may issue convertible bonds or share option rights, or the loan may be a profit participating loan. The company may issue options that can be traded separately (warrants).[76] Company and securities markets laws or the terms of the loan

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[75] Wiehe H, Jordans R, Roser E, Mezzanine Finance Structures under German Law, JIBLR 22(4) (2007) p 219.

[76] Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 38 number 15.

sometimes treat holders of such securities in the same way as they treat shareholders.[77]

An equity kicker can also be synthetic. A virtual equity kicker means that the lender receives a special payment that is linked to the increase of the value of the business.[78] The profit-related amount will often not be paid until the loan matures, because there might not be enough cash flow during the term of the loan.[79] Synthetic equity kickers or tag-along rights (section 20.7) are often used in venture capital and acquisition financing.

Alternatively, there may be a "non-equity kicker". A non-equity kicker means that the lender receives a fixed special payment that was previously agreed upon after the end of the term of the loan.[80] Back-ended payments can thus function as a "non-equity kicker". For example, a business acquisition contract may provide that the purchase price will be payable in instalments and that part of the purchase price will depend on the profitability of the target.

Convertible bonds, bonds with options (warrants). A real equity kicker requires the issuing of convertible bonds or debt securities with an option to subscribe for shares. Share options that can be traded separately are called warrants.

Convertible bonds are usually structured in two basic ways. (a) Traditional convertible bonds can be converted into shares issued by the debtor. The issuing of such convertible bonds requires a decision to issue those bonds, a decision to give subscribers of bonds the right to convert bonds to new shares, a decision to issue shares, and possible a decision to waive existing shareholders' pre-emptive rights. (b) Alternatively, convertible bonds can be synthetic and structured as derivative instruments. The issuer of synthetic convertible bonds can be the company that has issued shares or a third party.

The issuer of convertible bonds will have to decide on: conversion price (the price that will be paid by the lender on conversion); conversion ratio (the number of shares that the lender will receive on conversion); parity or conversion value; as well as conversion premium.

In Germany, convertible bonds and bonds with warrants can be issued by a public limited-liability company (AG)[81] but not by a private limited-liability company (GmbH), because the German Limited Liability Companies Act (GmbHG) does not provide for contingent capital (conditional capital, bedingtes Kapital). A GmbH should therefore structure equity kickers in other ways.[82] (For undercapitalisation, equity-replacing loans, and shareholder loans, see section 6.1.)

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[77] For German law, see § 3a and § 32b GmbH. See Wiehe H, Jordans R, Roser E, Mezzanine Finance Structures under German Law, JIBLR 22(4) (2007) pp 220–221.

[78] Wiehe H, Jordans R, Roser E, *op cit*, pp 220–221.

[79] *Ibid.*

[80] *Ibid.*

[81] § 221 AktG. See also §§ 192(1) and 193 AktG (bedingtes Kapital). For tag-along rights in a GmbH, see Diem A, *op cit*, § 38 number 17.

[82] See Wiehe H, Jordans R, Roser E, *op cit*, pp 220–221.

Participation certificates (Genussscheine) and ECAPS. In Germany, a limited-liability company may grant profit-sharing rights. Such rights are largely unregulated.[83] They are normally documented by issuing profit participation certificates (Genussscheine).[84] If certified, profit-sharing rights are transferable.

Participation certificates are regarded as loan instruments. Some Genussscheine are like bonds, with a regular coupon that can be delayed in hard times. Others are closer to equity, with dividend-like payments that can be cancelled under specified conditions.

According to the terms of the participation certificate, the lender provides capital to the company for a limited time. The lender is entitled to a stipulated yield. The lender's remuneration often consists of a minimum interest rate and a profit-related component. The lender may be given options or conversion rights to shares.

In the event of bankruptcy, the lender is normally a simple creditor. The parties may agree that the lender will participate in the losses of the company. For example, the parties may agree on subordination.

Similar techniques can be used in other countries as well. In the US, securities called ECAPS (Enhanced Capital Advantaged Preferred Security) will, like debt, carry routine payments and have finite (but long) maturities. At the same time, like dividends on shares, the interest payments can be deferred in times of financial stress. They can also be met by issuing extra shares at maturity.[85]

Interestingly, Genussscheine under German law are not the same thing as Genussscheine under Swiss law.[86] Genussscheine under Swiss law are not designed as an instrument to raise new external financing.[87]

Profit participating loans. Sometimes there can be a thin line between profit participating loans and partnerships or silent partnerships (stille Beteiligung) although the differences between these two forms of investment are large in theory. A silent partner is an owner rather than a mere investor. In Germany, the distinction can depend on two things. First, a profit participating loan is a mere exchange contract, but a silent partner pursues a joint purpose with the company. Second, claims based on a profit participating loan can be assigned, but a silent partner cannot assign his rights without the consent of the company.[88]

6.4 Share-based Mezzanine Instruments

Mezzanine instruments can also be based on shares. Share-based mezzanine instruments such as redeemable preference shares differ from mezzanine loans.

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83 See nevertheless § 160(1)(6) and § 221(3) and (4) AktG. See, for example, Kraft ET, Die Abgrenzung von Eigen- und Fremdkapital nach IFRS, ZGR 2–3/2008 pp 349–351.

84 § 793 BGB.

85 Chameleon bonds, The Economist, November 2005.

86 Art. 657 OR.

87 Barthold BM, *op cit*, pp 235–236.

88 Wiehe H, Jordans R, Roser E, *op cit*, p 219.

First, the obvious difference is that a mezzanine lender is regarded as a lender, but the holder of a share-based mezzanine instrument is regarded as a shareholder.[89]

Second, according to basic company law principles, all shareholders rank behind all creditors on a liquidation, but holders of mezzanine loan instruments rank in general only behind those to whom they have agreed to be subordinated.

Third, the distribution of funds to shareholders is constrained by mandatory provisions of company law which do not apply to mezzanine loans. For example, the main rule is that the company may provide security for the repayment of a mezzanine loan but not for the repayment of shareholders' capital.[90]

Fourth, whereas dividends on share-based mezzanine instruments will only be payable out of the distributable profits of the issuer,[91] interest on mezzanine loan instruments may be payable even in other cases.

Fifth, there are also restrictions on the ability of a company to redeem shares.[92] Typically, they may only be redeemed out of distributable profits or out of the proceeds of a fresh issue of shares.

Sixth, the holder of a share-based mezzanine instrument has normally no personal right to trigger the liquidation of the company.

Finally, the tax treatment of dividends on preference shares is also different from that applicable to interest on mezzanine.[93]

Differerent kinds of shares: ordinary, preference, tracking. Ordinary shares normally carry a right to participate in a company through voting and an entitlement to receive dividends. When a company is wound up, the ordinary shareholders will be the residual claimants.

It is also possible to issue ordinary shares which carry different rights. In many countries, a distinction is made between ordinary shares (that confer same rights or different rights) and particular preference shares.[94] Whether the amount paid to the company for preference shares is included in equity share capital or debt capital depends on the governing law.[95]

For example, preference shares are not included in equity share capital under *English* company law, because their rights differ from the ordinary shareholders' rights. English prefer-

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[89] See, for example, Barthold BM, *op cit*, p 234: "Die Vorzugsaktie nach Art. 654 OR ist in Bezug auf die Vorrechte dem Genussrecht des deutschen Rechts sehr ähnlich. Der Unterschied besteht jedoch darin, dass der Genussrechtsinhaber nach deutschem Recht nicht Aktionär der finanzierten Unternehmung sein muss, was der Berechtigte nach Art. 654 OR demgegenüber in jedem Fall ist. Die Vorzugsaktie dürfte dennoch das schweizerrechtliche Instrument für die Finanzierung von Unternehmensübernahmen und Jungunternehmen im Wege einer Mezzanine-Beteiligung sein."

[90] *Ibid*, p 237.

[91] Article 15(1)(a) of Directive 77/91/EEC (Second Company Law Directive).

[92] Articles 35–40 of Directive 77/91/EEC (Second Company Law Directive).

[93] Dyer R, Mezzanine Finance: Subordination and Priorities – an Overview, JIBL 5(4) (1990) p 154.

[94] See also Barthold BM, Mezzanine-Finanzierung von Unternehmensübernahmen, SZW/RSDA 5/2000 p 234.

[95] *Ibid*, pp 234–235.

ence shares carry a right to a fixed dividend. Holders of preference shares are entitled to their dividend before the ordinary shareholders. If the company is wound up, it is common for holders of preference shares to get repaid the par value of their shares before the ordinary shareholders get paid. On the other hand, preference shares do not normally give the holder the right to vote. Preference shares can also be redeemable or cumulative. Redeemable preference shares give the issuer the right to redeem them. Cumulative preference shares allow the holder to be paid a dividend in a later year if there are insufficient funds to meet the dividend in an earlier year. Under *Swiss* law, particular participation rights (Partizipationsscheine) resemble US-type preferred stock (rather than Genussscheine under German law).[96] Whereas Partizipationsscheine are share-based instruments and their holders are regarded as owners of the firm, the Genussscheine are debt-based instruments whose holders are regarded as creditors.[97]

Tracking shares (tracking stock, targeted stock) are a particular form of ordinary shares (or preference shares, as the case may be) that some companies have issued in addition to their traditional ordinary shares (or common stock).[98] The basic idea of tracking shares is that the financial interests of their holders are limited to a specific business unit or operating division of the company.

The company may prefer to issue tracking shares rather than obtain a separate listing for a subsidiary. A separate listing for a subsidiary would enable the market to separately value that subsidiary (which – through increased transparency – might increase the valuation of the parent company) but it would also increase legal constraints on the exercise of control ranging from the increased independency of the subsidiary's board from the parent to the rights of minority shareholders. Tracking shares enable the company to retain full control and have the benefits of the separate valuation of a division.

The value of tracking shares is designed to "track" or depend on the financial performance of a certain unit or division of a company rather than the operations of the company as a whole. For this purpose: the dividends that may be paid to holders of tracking shares depend on the performance of the business unit or division; tracking shares usually carry limited or no voting rights, and holders of tracking shares typically have limited or no claims on the company's assets in the event of liquidation. There is a downside, though: tracking requires a complex corporate structure which reduces flexibility; shares will, in practice, track the rest of the company as well; tracking increases conflicts of interest between shareholders; and tracking makes it more difficult for board members to fulfil their duties.

Tracking stock was first issued by *General Motors* (GM). When Ross Perot sold EDS to GM in 1984, part of his consideration was in GM shares (GM-E stock) that financially tracked the success of EDS rather than that of GM as a whole. In *Germany*, tracking shares were first issued in the context of the 2007 IPO of Hamburger Hafen und Logistik AG

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96 Art. 656a OR.

97 See Barthold BM, *op cit*, pp 234–235.

98 Åsbrink P, Spåraktien - ett nytt finansiellt instrument, JT vid Stockholms universitet 12 (2000–01) pp 380–393; Baums T, Spartenorganisation, „tracking stock“ und deutsches Aktienrecht, Institut für Handels- und Wirtschaftsrecht, Osnabrück, Arbeitspapiere 6 (1995).

(HHLA). The share capital of HHLA was made up of two different classes of shares, Class A shares (port logistics operations) and Class S shares (property operations). Only Class A shares were later traded on a share exchange. The articles of association of HHLA identified both classes of shares and both divisions - the "S-Division" and the "A-division".[99] The object of the company was defined differently for both divisions,[100] and the articles of association also defined the dividend rights of each class.[101] There were also other differences.

Community law. The use of different classes of shares or preference shares can increase flexibility under EU company law. This can be illustrated by four examples.

First, the Member States have an option not to apply the pre-emptive rights of shareholders to "shares which carry a limited right to participate in distributions … and/or in the company's assets in the event of liquidation".[102] It can therefore be easier to decide on the issuing of preference shares to new investors.

Second, the issuing of non-voting shares will not dilute the voting rights of existing shareholders in normal cases.

Third, the obligation to launch a mandatory bid under the Directive on takeover bids does not apply in the case of the acquisition of securities which do not carry the right to vote at ordinary general meetings of shareholders. Member States are, however, able to provide that the obligation to make a bid to all the holders of securities relates not only to securities carrying voting rights but also to securities which carry voting rights only in specific circumstances or which do not carry voting rights.[103]

Fourth, non-voting shares will not count when applying the break-through rule under the Directive on takeover bids.[104]

IFRS. Share-based mezzanine instruments can be regarded as equity or as a liability according to IFRS.

If an enterprise issues preference shares that pay a fixed rate of dividend and that have a mandatory redemption feature at a future date, the substance is that they are a contractual obligation to deliver cash and, therefore, should be recog-

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[99] Article 2(2) of the Articles of Association of HHLA: "The part of the Company which is concerned with acquiring, maintaining, selling, leasing, managing and developing real estate which is not specific to transhipment, particularly real estate in Hamburg's Speicherstadt and fish market (Real Estate subgroup), is described in Art. 31 of these Articles of Association and named the 'S-Division'. All other parts of the company (Port Logistics subgroup) are collectively called the 'A-Division' in these Articles of Association."

[100] Article 2(4) of the Articles of Association of HHLA: "The business activity of the Company and of it subsidiaries in the S-Division is performed having special regard to the interests of municipal development, tourism and the preservation of historical monuments."

[101] See Article 4 of the Articles of Association of HHLA.

[102] Article 29(2) of Directive 77/91/EEC (Second Company Law Directive).

[103] Recital 11, Article 2(1)(2) and Article 5(1) of Directive 2004/25/EC (Directive on takeover bids).

[104] Article 11 of Directive 2004/25/EC (Directive on takeover bids).

nised as a liability. In contrast, normal preference shares do not have a fixed maturity, and the issuer does not have a contractual obligation to make any payment. Therefore, they are equity.[105]

A contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the fixed monetary amount of the contractual right or obligation is a financial liability.[106]

When a derivative financial instrument gives one party a choice over how it is settled (for instance, the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.[107]

Compound financial instruments. Some financial instruments - sometimes called compound instruments - have both a liability and an equity component from the issuer's perspective. In that case, IAS 32 requires that the component parts be accounted for and presented separately according to their substance based on the definitions of liability and equity.[108]

To illustrate, a convertible bond contains two components. One is a financial liability, namely the issuer's contractual obligation to pay cash, and the other is an equity instrument, namely the holder's option to convert into common shares. Another example is debt issued with detachable share purchase warrants.

6.5 Profit-sharing Arrangements

In some countries, profit-sharing arrangements can be based on mezzanine instruments that are neither typical loans nor shares. In Germany, such instruments include silent participations (for partification certificates, see above).[109]

Defined in the German Commercial Code (HGB), a silent participation (stille Beteiligung) is a contract between the parties.[110] Silent participations are subject to registration requirements in limited-liability companies.[111]

A silent participation means that an investor makes a capital contribution to the firm. The contribution can be money, property, rights, or services.[112]

The investor and the company agree on informal articles of incorporation that set out the purpose of the venture, the objectives of the company, and the sharing of profits. A fixed interest rate is not sufficient; however, the parties may agree on

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[105] IAS 32.18.
[106] IAS 32.20.
[107] IAS 32.26.
[108] IAS 32.28.
[109] See Wiehe H, Jordans R, Roser E, Mezzanine Finance Structures under German Law, JIBLR 22(4) (2007) pp 219–220.
[110] §§ 230–237 HGB; §§ 705–740 BGB.
[111] § 292(1)(2) AktG.
[112] Article 27 of Directive 77/91/EEC (Second Company Law Directive) will not apply.

a minimum interest rate. A silent shareholder has controlling rights and a limited right to inspect the company's accounts.[113]

A silent participation is not a partnership agreement. A silent shareholder is thus not liable towards creditors. On the other hand, the silent shareholder and the company may agree on subordination and/or how the silent shareholder participates in the losses of the company.

In the event of bankruptcy, the silent shareholder may raise a claim for its capital contribution reduced by his share of losses.

Commerzbank, the second-biggest bank in Germany, accepted a capital injection from the government rescue fund (SoFFin, Sonderfonds Finanzmarktstabilität, Germany's Financial Markets Stabilisation Fund founded under the Financial Markets Stabilisation Act) in a bid to stabilise its capital base after losses mounted in 2008. SoFFin's silent participation of €8.2 billion was used to increase Commerzbank's Tier 1 capital (core capital).[114] As the participation was silent, the Federal Republic neither became a shareholder nor was given formal management powers or board memberships. Shares in the bank were still owned by its existing shareholders and the bank was managed by its existing board. De facto powers could, of course, not be excluded. The agreement with SoFFin stipulated that Commerzbank was prohibited from paying any dividends in 2009 and 2010. There was a cap on the salaries of members of the management board, and bonuses for 2008 and 2009 would not be granted.

[113] § 233 HGB.

[114] In addition, SoFFin granted Commerzbank Group guaranteed funding commitments; SoFFin promised to guarantee newly issued debt or other liabilities of Commerzbank up to 31 December 2009 to a total amount of €15 billion.

7 Chain Structures and Control

7.1 General Remarks

Pyramid structures and other control-enhancing mechanisms can provide a means to control legal entities with a smaller capital investment.[1] An external study commissioned by the Commission examined ownership and control of companies listed in the EU as well as the range and prevalence of legally available control-enhancing mechanisms (CEMs) in them.[2] The report identified 13 types of CEMs, ranging from pyramid structures and multiple voting rights to cross-holdings and shareholders' agreements.[3] According to the study, pyramid structures are the most important and widely available form of CEM in the EU.

Pyramid structures involve the chaining of several companies. A chain of legal entities where one entity controls a second entity, and the second entity a third one, enables an investor to control the last entity in the chain with a smaller capital investment, if each entity in the chain has raised funding from external non-controlling investors. The funding provided by external investors can be in the form of shareholders' capital, debt, or mezzanine financing.

The process can be repeated several times. The more times the process is repeated, the less capital the investor needs to control the last entity.

7.2 Examples of Cases

Well-known examples of chain structures include the Agnelli case, the Wallenberg case, and the Bouygues case.

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[1] See, for example, Morck R, Wolfenzon D, Yeung B, Corporate governance, economic entrenchment and growth, J Econ Lit 43 (2005) pp 655–720; Claessens S, Djankov S, Lang LHP, The separation of ownership and control in East Asian corporations, J Fin Econ 58 (2000) pp 81–112. See also Tricks of the trade, The Economist, June 2007; Pharaoh capitalism, The Economist, February 2009.

[2] Report on the Proportionality Principe in the European Union, 18 May 2007. It was prepared by Institutional Shareholder Services, the European Corporate Governance Institute, and Shearman & Sterling LLP.

[3] Multiple voting right shares; non-voting shares; non-voting preference shares; pyramid structures; priority shares; depository certificates; voting right ceilings; ownership ceilings; supermajority provisions; golden shares; partnerships limited by shares; cross-shareholdings; and shareholders' agreements.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
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The Wallenberg case. Chain structures and multiple voting-rights enabled the Wallenberg family to control some 40% of the value of the companies listed on the Stockholm stock exchange with a fraction of capital at the end of the 1990s.[4]

The Agnelli case. In Italy, FIAT S.p.A is controlled by the Agnelli family. Members of the Agnelli family have a stake in Fiat through a chain that begins with a limited partnership called Giovanni Agnelli e C. S.a.p.az.[5] In May 2008, the chain consisted of the following companies.

Giovanni Agnelli e C. S.a.p.az. owned shares of Istituto Finanziario Industriale S.p.A. (IFI). IFI had issued ordinary shares and preference shares. All ordinary shares were held by the limited partnership. The preference shares (which carried only limited voting rights) were listed on the Italian Stock Exchange. IFI thus functioned as a financial controlling holding company of the Agnelli Group but had external investors.

IFI owned shares of IFIL Investments S.p.A. (IFIL). IFIL had issued ordinary shares and savings shares (which carried no voting rights). Both classes of shares were listed on the Italian Stock Exchange. IFI owned 69.99% of the ordinary shares. IFIL was the main industrial holding company controlled by the Agnelli Group. The risks of the Agnelli Group were mitigated through ownership of 4.99% of the savings shares of IFIL by IFI and through direct ownership of 3% of the ordinary shares of IFIL by Giovanni Agnelli e C. S.a.p.az.

IFIL had holdings in several companies. Its most important investment was Fiat. Fiat is a large conglomerate with a wide range of operations ranging from automobiles to publishing. Like IFI and IFIL, Fiat had issued ordinary shares and preferred shares (with limited voting rights). IFI owned 30.45% of the ordinary shares and 30.09% of the preference shares of Fiat.

Giovanni Agnelli e C. S.a.p.az. could thus control Fiat through a chain of companies, each with external non-controlling investors.

The Bouygues case. Chain structures cannot work as control enhancing mechanisms and as a mechanism to reduce the funding needs of the firm unless there is a chain of entity A controlling entity B, entity B controlling entity C, and so forth. If the entity at the top loses control of other entities in the chain, the firm loses control of assets and is reduced in size. This can be illustrated by the Bouygues case.

Bouygues is one of the best-known groups in France. In the 1980s, members of the founding Bouygues family had a relatively small stake in Bouygues SA. They owned 100% of shares in SDCM, a private holding company. After a number of transactions, Bouygues SA was controlled by members of the Bouygues family.

Typically, SDCM and Bouygues SA invested in a joint venture in which a company controlled by SDCM owned the majority of shares and votes. Bouygues SA's interest in the joint venture was divided into a direct stake (shares in the joint venture) and an indirect stake (a minority stake in the company controlled by SDCM). Although Bouygues SA had a larger overall economic interest in the joint venture, the joint venture was controlled by the Bouygues family. This model was

[4] See Sweden's enduring business dynasty, The Economist, October 2006. See also figure 4–96 of the Institutional Shareholder Services, ECGI and Shearman & Sterling report.

[5] See, for example, Dynasty calls, The Economist, May 2008.

repeated. Gradually, SDCM obtained control of the business of Bouyagues SA with Boyagues SA providing the funding. Boyagues SA was ultimately taken over by SDCM.[6]

7.3 Legal Risks

7.3.1 Parent

The legal risks inherent in chains of companies are obvious. In addition to the risk of losing control of a key entity in the chain, there are even other risks.

First, the legal rights of the ultimate investor and the management of the firm as a whole are constrained by non-controlling shareholders rights, and minority shareholders may be able to block important decisions (Volume I). Like the Agnelli Group, the firm can mitigate this risk by introducing different classes of shares with different voting rights.

Second, the distribution of assets to entities higher up in the chain are constrained not only by the principle of equivalent treatment of shareholders in the same provisions, legal rules that protect minority shareholders in general, and legal rules that protect creditors (section 10.2). The most important constraint is that no profits may be distributed to shareholders unless there are distributable assets. In the Agnelli case, this risk was mitigated in three main ways. The ownership of a large block of the preference shares of Fiat, the main asset of the Agnelli Group, ensured that the Agnelli Group (IFIL) was entitled to a substantial amout of profits if profits indeed were distributed to the shareholders of Fiat. The entity highest up in the hierarchy owned 3% of the ordinary shares of IFIL meaning that the Agnelli Group could bypass one entity (IFI) when profits were distributed higher up in the chain. The entity highest up in the chain was a limited partnership in which the distribution of assets to owners was flexible.

Third, the legal constraints on the distribution of assets higher up in the chain lead to structural subordination (section 6.3.2). Combined with the high risk of expropriation of assets by the ultimate investor, the perceived risk of investors is bound to be high. This can have an adverse effect on the availability and cost of funding for companies in the chain and lead to a higher level of corporate risk. The risk is particularly high when the chain relies on one company for profits. In fact, the Agnelli Group almost lost control of Fiat in 2005.[7] The firm can mitigate this risk in many ways. In the Agnelli case, external shareholders of three chain companies (Fiat, IFIL, IFI) were offered preference shares and promised preferential treatment should the chain company actually distribute profits. Preference shares were in other words more senior than the ordinary shares held by the Agnelli Group. Furthermore, the Agnelli Group diversified its investments. Fiat was a

[6] Creative construction, The Economist, November 2006.
[7] Still in the driving seat, The Economist, October 2005.

conglomerate with a wide range of businesses.[8] IFIL, the main industrial holding company of the Agnelli Group, held stakes in other companies ranging from financial services firms to Juventus, a football club.[9] The limited partnership on top of the chain owned also Exor Group S.A. A privately-owned holding company incorporated in Luxembourg, Exor Group invested in other assets.

Fourth, high conglomerate discount caused by contributory legal risks means that the risk of a hostile takeover bid is increased unless the firm employs effective structural takeover defences in every company belonging to the chain. In the Agnelli case, the entity highest up in the chain was a limited partnership with no freely transferable shares, and external shareholders of the following companies in the chain had no or virtually no voting rights. Furthermore, the Agnelli Group controlled a relatively large amount of capital even in those companies, which would have made it difficult to apply the break-through rule (sections 10.3.2 and 19.9).[10] Generally, the ultimate investor can be exposed to a high level of counterparty commercial risk if it relies on shareholders' agreements and the co-operation of friendly shareholders for protection: If the conglomerate discount is high, it is difficult for other shareholders to obtain a high price for their shares. The existence of a takeover bid can give a strong incentive to sell.

Fifth, there are other legal risks ranging from the application of tax laws to restriction on the use of inside information.

7.3.2 Companies Lower Down in the Chain

In addition to the legal constraints discussed above, companies lower down in the chain can face other problems.

First, each limited-liability company is regarded as a separate legal entity. In the legal sense, each legal entity may have interests of its own. There can be a conflict between the legal duties of the company's board members and managers on one hand and the objectives of its controlling shareholder on the other (see Volume I).

Second, investments in companies higher up the chain are high-risk investments. When a company higher up in the chain (company A) collapses, a company lower down in the chain (company B) will have a problem. B will lose the

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8 Automobiles (Fiat, Lancia, Alfa Romeo, Abarth, Ferrari, Maserati and Fiat Light Commercial); agricultural and construction equipment (Case and New Holland); trucks and commercial vehicles, buses and special purpose vehicles (Iveco, Irisbus, Astra and Magirus); components and production systems (Fiat Powertrain Technologies, Magneti Marelli, Teksid and Comau); publishing and communications (La Stampa and Publikompass); financial services and rental services to customers.

9 IFIL had stakes in Fiat S.p.A., Cushman & Wakefield Group (real estate services), Sequana Capital S.A. (paper), Intesa Sanpaolo S.p.A. (banking), SGS S.A. (verification, inspection, control and certification activities), Gruppo Banca Leonardo S.p.A. (investment bank), Alpitour S.p.A. in which IFIL S.p.A. (tourism), and Juventus Football Club S.p.A.

10 Article 11 of Directive 2004/25/EC (Directive on takeover bids).

monies that it has invested in A's shares, and B may not be able to recover the sums that A owes to B any more than other creditors can.[11] B would need fresh capital because of the losses. However, B cannot ask A to inject new capital in B. This can lead to a domino effect with the bankruptcy of the parent followed by a chain of bankruptcies of subsidiaries.[12] Furthermore, in the bankruptcy of A, its assets would be managed by external administrators. What would happen with B's shares depends on the case. If the administrators have a duty to maximise the sums that can be distributed to A's creditors, they might: restructure A and let A keep the shares; sell the shares to the highest bidder; or decide to liquidate B.

For example, Chapter 11 enabled Delphi, a spin-off of General Motors, to reorganise its business in 2005. The transformation plan permitted Delphi and its US subsidiaries to reduce their pension liabilities and high labour costs, and the non-US subsidiaries of Delphi were largely unaffected by the process. In contrast, the bankruptcy of Oxford Automotive, another US-based supplier, resulted in the bankruptcy of its German subsidiary. In 2009, the subsidiaries of GM faced similar problems.

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11 See, for example, Peitsmeier H, Opel will nicht mit GM untergehen, FAZ, 17 November 2008 p 15: "Klar ist, dass General Motors seiner deutschen Gesellschaft mehrere Milliarden für Entwicklungsleistungen schuldet …"

12 See, for example, Preuß S, Roth M. Dominoeffekt für Merckle? FAZ, 7 December 2008 p 18.

8 Exit: Introduction

8.1 General Remarks

Returning funds to investors is the third of the four big decisions that can influence the firm's finances (investment, funding, exit, and existential decisions). This chapter will discuss how funds are returned to various kinds of external investors. Many risks are exit-related.

Investment, funding, exit, existence. To begin with, questions of investment, funding, exit, and the firm's existence are interrelated.

The firm's funding transactions can be someone else's *investment transactions*, and returning funds to investors can influence someone else's investment decisions.

For this reason, exit affects the firm in three main ways. First, an investor that has invested capital in the firm may want to release it and make a profit. As the firm will need funding even in the future, exit can create a risk. Second, the firm may be the investor looking for an exit. The firm will therefore have to manage the question of exit in the capacity of an investor. Third, the firm may be an investor whose risk exposure is influenced by other investors' exit decisions.

This can be illustrated by investment funds. Many investors in *open-ended* funds tend to have a short-term view. They can be affected by market sentiment, and there can be a big rush of redemptions at the same time. For this reason, the fund's own investment policy should be short-term as well. In *closed-end* funds where investors sign up for a period of, for example, 10 years, the fund can take a longer-term view in its own investment policy.

The initial choice of the *form of funding* (investors' investment) is one of the most important factors influencing exit, and one of the most important distinctions is that between: the exit of asset investors; the exit of debt investors; and the exit of shareholders. There are different legal constraints depending on the form of investment.

There are different legal constraints also depending on the *exit method*. Exit can depend on: whether the company will continue to exist as an independent legal entity or not; whether shares will continue to exist or not; whether payments will be made by the company or a third party; and other circumstances.

Corporate finance theory. According to the theory of corporate finance, the firm is expected to return excess cash to its owners according to their preferences if there are not enough investments that earn the hurdle rate. From a legal perspective, however, the firm should take into account other circumstances.

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Exit from the perspective of the firm, exit as an investment. From the perspective of the firm, returning funds to investors can be regarded as an investment. If given the choice, the firm would not make payments to its shareholders and other investors just to make them richer. The firm would make those payments if it made commercial sense to the firm itself.

Generally, the allocation of value generated by the firm is part of the management of agency relationships between the firm as principal and its stakeholders as agents (Volume I). Payments should preferably be made to each stakeholder category according to their relative importance to the firm and, in particular, the objective of the long-term survival of the firm.

Exit, cash flow, risk, agency, information. From the perspective of a non-financial firm raising the funding, the exit of an investor or the making of payments to investors can influence the firm in many ways. Exit can influence cash flow, risk, agency, and information.

Exit can influence the firm's funding mix and the cost of funding. Exit typically gives rise to risks that relate to liquidity, leverage, and access to funding.

Investors have an important role as sources of funding and providers of ancillary services. The exit of one or more investors can change the firm's agency relationships and agent mix.

For example, the question of exit is important from a corporate governance perspective. It goes without saying that it can change the firm's share ownership and control structure. Furthermore, exit can influence the firm's counterparty risks. The counterparty risks relating to the firm's remaining or new investors might not be the same after the exit of some investors.

Exit can signal something to the firm's investors, stakeholders, contract parties, customers, and market participants, and influence their behaviour. As exit can give rise to risks even in this respect, the firm should also manage exit as part of the management of the firm's outgoing information flows.

8.2 Exit from the Perspective of the Investor

There are general forms of exit that can be used in most investment transactions and particular exit forms that are, to a large extent, dependent on the type of investment. The general forms of exit include the following.

Sale to a third party. First, an investor can sell its claims to a third party. A shareholder can exit the firm by selling the firm's shares to someone else, and a creditor can sell the firm's debts to someone else. The sale of claims by one investor to another will not influence the firm's assets directly. It can nevertheless influence the firm and its assets in other ways (see below).

Cash payments by the firm. Second, the firm can make cash payments to the investor. If the investment is a loan, the firm is expected to fulfil its contractual obligations under the loan agreement. If the investor has invested in shares issued by the firm, there are legal constraints on whether and how the firm may buy them from the investor (share buy-backs), withdraw them, or make other distributions.

Conversion. Third, the claims can be converted into other claims without the firm making any payments in cash. For example, a loan may be converted into another loan (novation), and the investor may have a right to subscribe for a number of shares under the terms of a convertible bond. A share exchange means that a shareholder will become shareholder of another company. A formal merger means that a shareholder will either become shareholder of the surviving entity or receive other consideration for his shares. A demerger means that a shareholder can become a shareholder in a new company.

Changing the quality of claims without conversion. Fourth, the nature of the investor's claims can be changed through one or more transactions without converting them into new claims. This will often make other forms of exit easier.

New equity investment can make debt instruments issued by the firm look more attractive by reducing credit risk, and an LBO of the firm tends to make its debt instruments less attractive because of a higher credit risk after refinancing.

A share exchange or merger can mean that a large and illiquid block of shares is converted into a smaller and more liquid block of shares. For example, a reverse takeover can change illiquid shares of a small listed company into more liquid shares of a far larger company, and the illiquid shares of a large privately-owned company into more liquid shares of a listed company.

Admission of the company's securities to trading on a regulated market can generally turn illiquid securities more liquid.

Particular forms of exit. Fifth, there are even particular forms of exit depending on the investment.

For example, a simple term loan will be repaid on a certain date. A bank might sell and transfer the loan before the repayment date.

In contrast, a limited-liability company cannot freely repay capital invested in the purchase of shares issued by the company. A shareholder can nevertheless exit the company in many ways. Shares can be sold. A large shareholder can offer shares to the public. Shares can be bought back by the company, or the shares can be withdrawn.

Asset investors can exit the firm in various ways depending on the investment. For example, an entrepreneur might personally own part of the core assets of the firm (such as intellectual property rights or real estate). If the firm is successful, the value of those assets might increase. The entrepreneur might then exit the firm by selling not only his shares but also those assets; the firm is de facto forced to buy the assets if they belong to its core assets.

Walking away. Sixth, the investor may prefer simply to walk away. As a rule, all kinds of investors can walk away, but walking away is constrained by the invetors' own obligations and interests.

For example, bad debts have an accounting life cycle. A bank would set the portion of the loan portfolio that it does not expect to collect to the bad debt provision expense account. When the bank identifies a potential loan loss, it increases its loan loss provisions. Potential losses are not immediately written off from the gross loan balance. When the bank's legal rights to a bad debt are extinguished (for example, when a bad debt is sold), the bad debt will be derecognised and losses will be written off.

In a limited-liability company, the main rule is that a shareholder can write down the value of shares and let the company collapse. (a) According to IFRS, some financial assets should be measured at fair value (IAS 39). Fair value of an asset means the amount for which the asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. (b) According to company laws, a normal shareholder usually has no legal obligation to make any payments to the company apart from the amount payble for the shares. Controlling shareholders can nevertheless be subject to a stricter regime in some jurisdictions. For example, the actions of a controlling shareholder can be constrained by the doctrine of lifting the corporate veil (England), the doctrine of Durchgriff (Germany), group laws (Konzernrecht under German law), or similar doctrines. In some cases, a controlling shareholder can be made responsible for loss sustained by other investors through its own actions.

Investors walking away tends to signal low quality of the investment and to increase funding costs for the firm. One of the ways to mitigate this risk has been to hide the firm's bad debts in SIVs as was done in the Enron case. The widespread use of SIVs was one of the reasons why the 2007 subprime mortgage crisis did not become known earlier.

8.3 General Remarks on the Management of Risk

8.3.1 Introduction

As investors can exit the firm in many ways, the firm can be exposed to a wide range of exit-related risks. Some general remarks can nevertheless be made. Typical risks often relate to: replacement and refinancing; ownership structure and control; counterparty and agency relationships; as well as information and reputation.

8.3.2 Replacement Risk and Refinancing Risk

After the exit of an investor, the firm may find it difficult to replace the original funding arrangement with a similar arrangement (replacement risk). The lack of funding can, in the worst case, make the firm insolvent, as was seen during the financial meltdown which began in 2007 (section 2.5). Even when the firm remains able to repay its debts when due, the firm may have to pay more for its funding (refinancing risk). The firm can mitigate replacement and refinancing risks by legal tools and practices.

Choice of the form of payment obligations, choice of funding instruments. At a general level, cash flow can be influenced by the choice of the form of the firm's payment obligations (for a taxonomy of payment obligations, see Volume II). Different payment obligations are combined with different levels of managerial dis-

cretion. A high level of managerial discretion can help to mitigate the adverse effects of exit.

In particular, the firm can choose between funding that will have to be repaid (such as debt) and payment obligations that give the firm more managerial discretion (such as shares).

In a limited-liability company, the use of shares as a source of funding means that exit will be constrained by legal rules that regulate the withdrawal of shares, share buy-backs, financial assistance, the payment of dividends, and generally the making of distributions to shareholders.

Equity technique. Generally, the equity technique can help to mitigate the risk that the firm must make payments to investors when it needs funds the most. The equity technique can be supported by mandatory provisions of law (such as company law provisions that regulate the distribution of funds to shareholders) or contractual clauses (such as the terms of debt mezzanine instruments according to which the repayment of debt is subject to restrictions).

Lock-up clauses. Contractual lock-up clauses can delay an investor's exit from the firm.

For example, a hedge fund or a private equity fund could ask investors to agree to a lock-up according to which they must keep their money in the fund for a minimum period. In a hard lock-up, investors have no right to redeem before their time is up. In a soft lock-up, they can get out early but have to pay a redemption fee of, say, 3%-5%. Most funds manage to bargain for one to two years. A five-year lock-up would be unusual in that industry.[1]

Lock-up clauses can also be found in IPOs. The fear of large-scale sales of shares by other investors can depress share price. For this reason, the firm might prefer to use a lock-up agreement with important investors (such as banks, institutional investors and large shareholders) to limit the sale of shares during an IPO process. If large investors must not sell their shares during a lock-up period, the lock-up clause can signal to smaller investors that there will not be any massive sales of shares just after they have subscribed for shares. This can reduce perceived risk and encourage smaller investors to pay more for the shares.

For the firm, the benefits of lock-ups are clear. Lock-ups can help the firm to match assets and liabilities. It would be riskier for the firm to invest, say, in an illiquid three-year project if the firm's own investors could take their money back within a year. Lock-ups can thus help the firm to invest in long-term assets or less liquid assets. Lock-ups can also help to attract long-term investors by reducing the risk that the investment project will fail after important investors have pulled out at an early stage of the project.

A further benefit is that funding which is long-term because of lock-up clauses can function as a functional equivalent to equity, act as a credit enhancement, and reduce overall funding costs.

However, the drawback is that lock-ups generally increase the illiquidity of investments. They may keep out some investors.

[1] All locked-up, The Economist, August 2007.

Termination and acceleration clauses. Termination clauses, acceleration clauses and similar clauses set out the agreed terms of exit in long-term contracts. The firm should therefore pay attention to such clauses.

In debt contracts, termination or acceleration is often triggered by the occurrence of an event of default. The definition of events of default is therefore important. Particular cross-default clauses (section 4.3 and Volume II) can multiply risk.

Cirio, an Italian processor of food, was a case of cross-default in 2002. Cirio's investors expected the repayment of €150 million when their bonds matured, but Cirio did not have those funds. This was serious, because default on any bond repayment could have triggered a cross-default, immediate demands for repayment of all other bonds issued by the company, and a need to find a total of €1.1 billion in cash for its bondholders.[2]

8.3.3 Risks Relating to Ownership Structure and Control

The exit of one or more investors can influence the share ownership or control structure of the firm. For example, the nature of the firm will change if one shareholder obtains control after buying other shareholders' shares, and the firm might be affected even where the firm's main bank sells the firm's debts to one or more other financial institutions. There are many typical ways to mitigate such risks.

Control. The use of shares raises the question of control. The firm should ensure that it has the control structure it needs before and after the exit of a shareholder (see Volume I).

Restrictions on the transfer of shares. For example, there can be restrictions on the transfer of shares.

The firm can limit the transferability of shares by remaining private. If there is no functioning market, it is more difficult for a shareholder to sell shares and more difficult for a potential buyer to make a hostile bid for them. Moreover, the articles of association of a privately-owned company may, depending on the governing law, make the purchase of shares subject to further constraints.

In contrast, shares and other securities admitted to trading on a regulated market must be freely transferable.

In both listed and privately-owned companies, the main shareholders can agree not to sell their shares or on similar exit restrictions.

For example, Arsenal Football Club plc, a famous football club based in London, was controlled by its board members who were also its main shareholders. They had a "lockdown agreement" not to sell their shares until April 2008 at the earliest. This kept Arsenal safe from an attempted takeover in 2007.

The firm may also implement other structural takeover defences (Chapter 18). Strategic takeover defences include: block-holding by friendly shareholders; structural devices relating to shares (various classes of shares with differentiated voting rights, special control rights conferred on holders of a specific class of shares,

[2] Cirio folks, The Economist, November 2002.

pyramid structures or cross shareholdings, general voting caps for shareholders); and structural devices relating to control (such as shareholder agreements).

Restrictions on the assignment of debt claims. In principle, the firm could also agree with a debt investor that the investor may not freely assign its claims to a third party. In practice, however, few debt investors would be willing to accept such restrictions that increase risk.

8.3.4 Counterparty Risks (Agency) in General

The sale of a debt claim or shares can generally be contrary to the firm's interests where the buyer is either less likely to comply with its contractual obligations towards the firm or more likely to act in a hostile way or otherwise contrary to the firm's interests.

For example, the expected future behaviour of the parties can depend on business culture. A German bank doing business with German customers is likely to be subject to reputational constraints in Germany. It has long-term interests in Germany. If the bank assigned its loan portfolio to, for example, a financial institution based in Dallas, Texas, those reputational constraints would be lifted because a Texas bank has virtually no fundamental long-term interests in the German market. In addition, it would be part of the business culture of the Texas bank to look for shorter-term benefits. The customer could therefore prefer not to have its debts assigned in the first place.

Assignment of claims. As far as debt claims are concerned, a standard way to mitigate this risk is to prohibit both the assignment of the contract as a whole and the assignment of claims under the contract.

The prohibition of the latter would require an express agreement. The main rule under contract law is that a party may assign its rights but not its obligations unless the parties agree otherwise. Sometimes the firm's contract party may have been given a right to transfer not only its rights but also its obligations (the contract as a whole, or the rights and obligations attaching to shares).

Sale of shares. There can also be restrictions on the sale of shares (see above).

8.3.5 Information and Reputational Risk

The management of information belongs to the most important elements of the management of exit. The exit of an investor and the firm's own actions can signal something to investors and stakeholders.

Effect of exit constraints on funding. The level of the freedom of exit influence investors' perceived risk and thereby also the firm's access to funding and its cost.

Their effect depends on the preferences of the investor. Lock-up provisions can signal higher risk to short-term investors whose investments are covered by the lock-up, but lower risk to long-term investors whose investments are not covered by the lock-up. The free transferability of shares can signal lower risk to shareholders, but the existence of effective restrictions on the distribution of funds to

shareholders and a strict rule on the equivalent treatment of shareholders can signal lower risk to minority shareholders in a company which has a controlling shareholder.

Effect of exit on perceived quality of financial instruments. In addition, the perceived quality of financial instruments issued by the firm can be influenced by whether and how existing investors transfer their claims. The sale of debt claims at a large discount can signal that they are of poor quality. The impact is bigger when the sellers are investors who are perceived as a reliable source of information. Sales by insiders signal their opinion of the outlook of the firm.[3] The firm might therefore prefer to control the transfer of those claims (for transferability, see Volume II).

Where shares are traded on a regulated market, investors will want to know what insiders do with their shares. EU securities markets law requires disclosure of share transactions in some cases. (a) The Market Abuse Directive provides that "[p]ersons discharging managerial responsibilities within an issuer of financial instruments and, where applicable, persons closely associated with them, shall, at least, notify to the competent authority the existence of transactions conducted on their own account relating to shares of the said issuer, or to derivatives or other financial instruments linked to them". In addition, "Member States shall ensure that public access to information concerning such transactions, on at least an individual basis, is readily available as soon as possible".[4] (b) The Transparency Directive lays down an obligation to disclose information about major holdings.

Mitigation of risk. The firm can mitigate this risk in many ways. One of the ways to mitigate it is by ensuring that the firm's key shareholders are long-term investors who are not looking for short-term or private benefits contrary to the interests of the firm.

The firm can generally signal the quality of its shares by using information intermediaries. For example, if the shares are sold by the firm's existing owners, the choice between a trade sale and an IPO can be important. In a trade sale to one buyer, the buyer can assess the quality of the shares. In an IPO to the public, most investors lack the expertise; investors might therefore assume that it is the right time for the firm's owners to sell at that price (and that it is not time to buy those shares at that price).

This can be illustrated by the case of Iittala Group Oyj, a Finnish homeware design company. In 2007, Iittala shares were owned by ABN AMRO Capital (a private-equity firm), the company's management, and other private shareholders. A planned IPO by means of selling existing shares to the public failed to convince investors. After the failed IPO, 98% of Iittala shares were sold to Fiskars Corporation, another Finnish homeware design company. Fiskars was in a better position to assess the quality of the shares.

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[3] For example, when Blackstone, a large private-equity group, and its owners sold Blackstone's shares to the public in 2007, the sale was interpreted as a signal of the private-equity market already having reached its peak. See Dramatic entrance, The Economist, June 2007; Saving Steve Schwarzman, The Economist, September 2007; Lifting the lid, The Economist, January 2007.

[4] Article 6(4) of Directive 2003/6/EC (Directive on market abuse).

If existing shareholders keep their shares and promise not to exit the firm in the near future (lock-up), new investors might be willing to pay more. However, there is still the risk that the price is too high; a high price would dilute the holdings of existing shareholders less. If new but knowledgeable long-term institutional investors are prepared to subscribe for the shares at that price, less professional investors might assume that the price is not too high.

9 Exit of Different Classes of Investors

9.1 General Remarks

The management of risk depends on the type of investment. Also the regulation of exit depends on the form of investment. In the context of exit, there are three types of investors: asset investors; debt investors; and shareholders.

The exit of private asset investors and debt investors is based on contract. Simply put, the exit of private asset investors is constrained in particular by contract terms and provisions of property law, and the exit of debt investors is constrained in particular by contract terms and provisions of insolvency law.

The exit of shareholders depends on the business form. In a limited-liability company, it is regulated by mandatory company law provisions that protect the company, its creditors and other shareholders.

9.2 Exit of Asset Investors

The term "asset investors" here means investors who have invested tangible or intangible assets other than money in the firm. There are various kinds of asset investors ranging from owners of premises in which the firm operates to owners of intellectual property rights that the firm may use under a licence agreement, and from providers of operational leasing services to network partners whose distribution channels or resources the firm uses in its operations. In a broad sense, even employees and managers who have invested their human capital in the firm can be regarded as asset investors.

Such asset investors can be regarded as *private* asset investors. In a broad sense, the state and similar public bodies can be regarded as *public* asset investors when they provide public goods that can be used not only by the firm but also by others. The state and other public bodies can also act in the capacity of private asset investors. Subsidies and state aids belong to other forms of public-sector investment in the firm (for state aids, see Volume II). In the following, "asset investors" refers to private asset investors.

Characteristics of asset investment. It is characteristic of asset investment that the investor owns an asset and permits the firm to use it in exchange for payment of remuneration (rent). As the owner of the asset, the investor may have a right to withdraw it or prohibit the firm from using it. As the firm is not the owner of the

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asset, the firm may have a legal obligation to return the asset or cease using it. If the firm purchases the asset from the investor, the firm will pay a purchase price.

Risks. This gives rise to five important risks. (1) The withdrawal or repossession of assets that the firm uses in its business operations can cause operational problems (operational risk). (2) It can be difficult to replace the asset (replacement risk). (3) Even if the firm were able to replace the asset, it might cost the firm more (refinancing risk). (4) In some cases, the firm is so dependent on the continued use of the asset that it becomes exposed to the risk of hold-up. (5) If the owner of the asset transfers ownership to somebody else, counterparty commercial risk can change, because the new owner is either more likely or less likely to withdraw the asset than the original owner was, and either more likely or less likely to abuse its position than the original owner was.

Management of risk. The firm will typically manage such particular risks in the following ways (see also sections 3.3.3 and 3.3.4; for assets used as collateral, see Volume II).

The first is ownership. The firm should own its core assets. This can lead to vertical integration. For example, if the firm is dependent on a large distributor for the distribution of its products, the firm may prefer to mitigate risk either by acquiring the distributor or by establishing a subsidiary of its own and transferring the distributorship to its subsidiary.[1] In addition, the firm can ensure that its core assets are not owned by the same external party.

The second is through the regulation of the contract period and termination. The firm can mitigate risk through contract terms that: provide for a long contract period; limit the investor's right to terminate the contract prematurely; provide for a long notice period when the contract is terminated by the investor; permit the firm to terminate the contract in an easier way; and give the firm an option to buy the asset on termination.

The third is by limiting both the right of the investor to transfer ownership of the asset to a third party and the right of the investor to assign the contract to a third party.

Legal constraints on performances to asset investors. Legal constraints on performances to asset investors depend on the asset and the type of investment. Gen-

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[1] The legal framework of the firm's distribution channels can be understood as a process. The firm starts with direct sales to customers in the market. Commercial agency provides access to established distribution channels. However, commercial agents typically lack financial resources to invest in sales and marketing. Sooner or later the firm will terminate the commercial agency relationship. The parties have therefore regulated the terms of the termination of the commercial agency relationship in detail. As the weaker party, the commercial agent is protected by mandatory provisions of law based on Directive 86/653/EEC (Directive on commercial agents). A sole distributor typically has better financial resources compared with a commercial agent. However, both the sole distributor and the principal know that the principal will want to terminate the sole distributorship contract if the sole distributor either does not do well or does very well. Even in this case, the parties have regulated the terms of termination in detail. The terms of commercial agency contracts and distributorship contracts reflect this process.

erally, usual constraints can be based on contracts, provisions of the law of property, insolvency law, and provisions of company law.

The parties may agree on payments to asset investors. The firm's contracts with other investors can nevertheless contain covenants that prohibit unusual transactions or require the lenders' prior consent (section 4.3 and Volume II).

The law of property (Sachenrecht) acts as a constraint, because the firm cannot validly return assets to an asset investor where a third party has a right that prevails over the asset investor's rights. For example, provisions of the law of property can influence the characterisation of the transaction under which the firm may use the asset; depending on the governing law, a financial leasing transaction might be characterised as a hire-purchase agreement (section 3.3.3), and a sale and lease-back transaction might be characterised as an assignment by way of security rather than a "true sale" (section 3.3.4).

The characterisation of the transaction will be very important in the insolvency of the asset investor or the firm. Insolvency laws are typically mandatory.

Provisions of company law can act as a constraint as in any transaction. For example, members of the board owe a duty of care and fiduciary duties to the company, and payments to shareholders are constrained by restrictions on the making of distributions to shareholders and the principle of equivalent treatment. If the owner of the asset is a shareholder, excessive or unnecessary payments may amount to a breach of such rules.

9.3 Exit of Debt Investors

The exit of debt investors has already been discussed in the context of the performance of monetary obligations (Volume II), the transfer of claims (Volume II) and the risks inherent in debt funding (section 4.2).

Exit. A debt investor can release capital in two main ways. First, the debtor can fulfil its payment obligations or the investor may ask the debtor to fulfil them through acceleration or otherwise. The main traditional ways to discharge a monetary obligation are through payment, set-off, and netting. Second, the debt investor can transfer its claims.

Mitigation of risk. As debts are repayable, there are three particular basic ways to mitigate the risk inherent in the exit of a debt investor. First, the firm should ensure that it has enough managerial discretion (section 4.2) under the loan facility, and the firm should also ensure that the necessary repayment of debts will not be constrained by the firm's contractual obligations to other providers of funding (covenants). Second, the firm can mitigate risk by using the equity technique (section 6.3). Third, the firm can also restrict the right of the lender to transfer its claims (section 4.2 and Volume II). Restrictions on the transferability of claims can be necessary because of the signalling effects of the transfer of claims.

9.4 Exit of Shareholders

The exit of a shareholder in his capacity as shareholder depends on the business form of the firm. While there is a large body of company law rules on the exit of shareholders, the parties have more discretion in partnerships.

Shareholders can exit a limited-liability company in many ways. Funds can be paid either by the company (distributions, share buy-backs, withdrawal or redemption of shares, liquidation) or by a third party (sale of shares, public offerings, the use of a sell-out or squeeze-out right, share exchanges, consideration in the context of a merger or a division). The company will either continue to exist as a legal person or cease to exist (liquidation, merger, division). If the company continues to exist as a legal person, the shareholder's shares will either continue to exist (sale, share exchanges, share buy-backs) or will cease to exist (withdrawal of shares).

A shareholder can simultaneously be an asset investor and/or a debt investor. For example, a shareholder might personally own part of the core assets of the firm such as intellectual property rights (patents, trademarks) or real estate. If the firm is successful, the value of those assets might increase. The shareholder might then exit the firm in the capacity of asset investor by selling those assets to the company or a third party. As shareholders are residual claimants, a shareholder can sometimes mitigate risk by using debt instruments. The firm must repay its debts even in the absence of distributable profits.

10 Exit of Shareholders

10.1 Introduction

In a limited-liability company, the exit of shareholders is constrained by a large number of mandatory provisions of company law. In Community law, many of such provisions belong to the core of the European legal capital regime. However, there can only be piece-meal harmonisation of exit-related questions in the EU because of the wide range of different ways to exit a company.

At a very general level, the forms of the exit of shareholders can be divided into four standard categories: cash payments made by the company; cash payments or consideration other than in cash made by a third party; mergers and divisions; and a combination generally known as refinancing.

In addition, there are existential questions at the level of the company and at the level of its shareholders. Payments can be made to shareholders when a company is liquidated. Where a shareholder ceases to exist or becomes insolvent, that shareholder's assets may be liquidated. Such existential questions will not be discussed here.

10.2 Cash Payments by the Company

10.2.1 General Remarks

Cash payments to shareholders are generally constrained by the legal capital regime and the Second Company Law Directive.

Core constraints. There are four core constraints: the distribution of funds must not be made when the net assets are lower than the subscribed capital or minimum capital or when the net assets would fall below that threshold;[1] there must be equal treatment of all shareholders who are in the same position;[2] the acquisition, redemption and withdrawal of shares requires a resolution by the general meeting and usually a majority of at least two-thirds[3] and may require class consents when

[1] Articles 8 and 34 of Directive 77/91/EEC (Second Company Law Directive).
[2] Articles 19(1) and 42 of Directive 77/91/EEC (Second Company Law Directive); Article 17(1) of Directive 2004/109/EC (Transparency Directive).
[3] Article 40 of Directive 77/91/EEC (Second Company Law Directive).

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they vary class rights;[4] and the reduction of subscribed capital requires compliance with a creditor protection mechanism.[5]

Increasing the amount of distributable assets. The company can increase the sum that can be distributed to shareholders in many ways. The sale of assets not only releases capital and increases liquidity but can also, depending on their previous book valuation and the applicable accounting standards, increase distributable assets (section 10.2.2 below). In addition, the fair value accounting of financial assests can help to increase the firm's distributable profits when times are good (Volume I).

Why make payments? The company can make payments to shareholders for many reasons. Generally, shareholders want to be remunerated for their investment in the company's shares or for their ancillary services (for the function of shareholders, see Volume I). Payments to shareholders are a way to influence share price. If the company's shares are traded on a stock exchange, a low market valuation combined with the chance to distribute plenty of assets to shareholders would be an invitation to make a bid for the company's shares (and make a windfall profit after the merger of the acquisition vehicle and the target company, see section 10.5).

Depending on the method of making payments to shareholders, it is also a way to manage the company's shareholder base. For example, *Ferran* has listed the following reasons for companies to use share buy-backs or issue redeemable shares: to attract external investors; to facilitate exit; to structure a temporary loss of control; to return value to shareholders; to give information signals; to achieve a target capital structure; to expand the range of financial options; to buy back redeemable shares at a discounted price; to facilitate the organisation of employee share schemes; to achieve an informal reduction of capital; to defend against a takeover or deal with dissident shareholders; and to stabilise share price.[6]

Choice of method of making payments. The company can return funds to shareholders in many ways. The company can pay dividends, purchase shares, and reduce capital. The choice between the different methods will be affected by a range of considerations, including the differences in tax treatment of the various options and the varying opportunities they offer for managing the shareholder base. The payment of dividends will not change the company's shareholder base. Reductions of capital and buy-backs can be used to reduce the number of shares in issue and – subject to constraints caused by the principle of equivalent treatment of shareholders – also the company' shareholder base. Whereas share buy-backs are only possible where there are willing sellers, the reduction of capital procedure can – again subject to constraints – be used to pay off shareholders against their wishes.[7]

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4 Articles 31 and 38 of Directive 77/91/EEC (Second Company Law Directive).

5 Articles 30 and 32 of Directive 77/91/EEC (Second Company Law Directive).

6 Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 203–208.

7 *Ibid*, pp 191–192.

10.2.2 Dividends and Other Distributions

The payment of dividends is one of the main ways to reward existing shareholders, and a company firm is usually expected to pay dividends during the normal course of business.

Reasons to pay dividends. Dividends are again paid for a wide range of reasons.

In a corporate group, the payment of dividends and intra-group asset transfers are commonplace.

For companies whose shares have been admitted to trading on a regulated market, the payment of dividends is an important signalling tool as increasing dividends over a long period of time can be perceived as evidence of sustainable earnings growth. This can reduce perceived risk and increase share price (and make it necessary to use share buy-backs for one-off distributions; share buy-backs are more flexible than dividends because they have not become associated with raised expectations with regard to future payouts).[8] Many investors prefer companies that pay dividends as they rely on dividends for their income; even this can increase share price in practice.

This means that shareholders fulfil their monitoring role (Volume I) partly by expecting the payment of dividends. According to *Easterbrook*, "expected, continuing dividends compel firms to raise new money in order to carry out their activities. They therefore precipitate the monitoring and debt-equity adjustments that benefit stockholders."[9] This means also that the dividend policy of the firm is a way for managers to impose discipline on themselves.

There can be even other reasons to pay dividends and distribute funds to shareholders. For example: distributable assets are often distributed to existing shareholders before an IPO; a company whose shares are traded on a regulated market can pay dividends and make other distributions to existing shareholders as a takeover defence; dividends can be paid after a successful takeover, because it will help the buyer to repay takeover bridge loans; and the payment of dividends can be used instead of a division to split the company into two businesses (for divisions, see section 10.4.4).

The practice of dividend policy and the legal aspects of distributions can be contrasted with corporate finance theory. The theory is that dividend policy should not affect the overall market value of a company's shares if the markets are perfect.[10]

Distributable assets. The term used in the Second Company Law Directive is "distribution". There are general constraints on the "distribution" of funds to shareholders.[11] The term "distribution" includes, in particular, the payment of

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8 See *ibid*, citing Oswald D, Young S, Cashing In On Share Buybacks, Accountancy (2003) p 55.

9 Easterbrook FH, Two Agency-Cost Explanations of Dividends, 74 (1984) Am Econ R p 650, cited in Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) p 235.

10 See Ferran E, *op cit*, citing Miller MH, Modigliani F, Dividend Policy, Growth and the Valuation of Shares, J Bus 34 (1961) p 411.

11 Articles 15–24 of Directive 77/91/EEC (Second Company Law Directive).

dividends and of interest relating to shares.[12] There are similar constraints on the payment of interim dividends.[13]

The Second Directive provides that "no distribution to shareholders may be made when on the closing date of the last financial year the net assets as set out in the company's annual accounts are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes", unless the subscribed capital is reduced.[14] Furthermore, the amount of a distribution to shareholders may not exceed the amount of the profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the statutes".[15]

In other words, the Second Directive sets out two cumulative restrictions: the net assets of the company and the net profits of the previous financial year. As this is a minimum requirement, Member States' laws may restrict the distribution of funds even more.[16]

What does the term distribution mean? The term "distribution" has not been defined in the Second Directive and is therefore a matter of interpretation of Community law.[17] This can increase legal risk.

For example, is the sale of assets at an undervalue to a buyer who happens to be a shareholder a form of "distribution" under Community law? Is the extension of credit on terms that are more favourable than market terms or in a situation where no third party would have received a credit a form of "distribution"?

The wording of the Second Directive implies that the term "distribution" must mean a transaction that reduces net assets set out in the company's annual accounts.[18]

The *German* Aktiengesetz prohibits hidden distributions.[19] Distributions must therefore be made in compliance with the statutory procedure. In *England*, "it would be ultra vires the company to distribute assets of a company to the shareholders other than by way of a distribution of profit lawfully made or by a reduction in capital duly sanctioned by the court or possibly a return of capital by the adoption of a special procedure under the Companies

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[12] Article 15(1)(d) of Directive 77/91/EEC (Second Company Law Directive). For German law, see § 30(1) GmbHG.

[13] Article 15(2) of Directive 77/91/EEC (Second Company Law Directive).

[14] Article 15(1)(a) of Directive 77/91/EEC (Second Company Law Directive).

[15] Article 15(1)(c) of Directive 77/91/EEC (Second Company Law Directive).

[16] Schwarz GC, Europäisches Gesellschaftsrecht. Nomos, Baden-Baden (2000) pp 379–380. For German law, see § 30(1) GmbHG and § 57 AktG.

[17] See Werlauff E, EU Company Law. Second Edition. DJØF Publishing, Copenhagen (2003) p 280: "Community law contains no direct provisions on disguised or secret distribution to the shareholders."

[18] See Schwarz GC, Europäisches Gesellschaftsrecht. Nomos, Baden-Baden (2000) p 379: "Unter Ausschüttungen sind ... alle Leistungen zu verstehen, durch die eine – in Art. 15 Abs. 1 Buchst. A Zweite RiL definierte – Unterbilanz herbeigeführt oder vertieft wird."

[19] § 57 AktG.

Acts".[20] The interpretation of the term distributions under the Companies Act 2006 therefore overlaps with the doctrine of ultra vires.[21] Under the Companies Act 2006, the term distribution has basically been defined as "every description of distribution of a company's assets to its members, whether in cash or otherwise";[22] this very open definition (a distribution is a distribution) has been complemented by listing exceptions which have been regulated otherwise.[23]

Decision-making. Decisions on the payment of dividends will be taken in two stages. There will be a decision on the profits available for distribution. That decision will be followed by a decision on the payment of dividends. As rules on decision-making have not been harmonised at Community level, the provisions of Member States' national company laws apply. Typically, both decisions are controlled by the board, although the general meeting may be given a veto right.

Under *German* law, the management board of an AG approves the annual financial statements and submits them to the supervisory board with its proposal as to the appropriation of the annual net profit.[24] The proposal sets forth what amounts of the annual net profit should be paid out as dividends, but the net profit is determined only after certain amounts have been transferred to capital reserves or carried forward to the next fiscal year.[25] According to the Aktiengesetz, the two statutory boards may not allocate more than one half of the annual surplus to profit reserves, unless the articles of association provide otherwise.[26] There are even other specific provisions dealing with the allocation of the annual surplus to reserves.[27] Upon approval by the supervisory board,[28] the management board and the supervisory board submit their combined proposal to the shareholders at the annual general meeting. The general meeting decides on the distribution of profits,[29] but it is bound by the proposal as regards the determination of the amount of annual net profits.[30] This means that the management board and the supervisory board normally have the final say in the dividend policy.[31]

According to *English* company law, the division of power between directors and shareholders will be settled by the company's articles of association. The Companies Act 2006 is

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[20] Ultraframe (UK) Ltd v Fielding & [2003] EWCA Civ 1805, citing Aveling Barford Limited v Perion Limited [1989] BCLC 626 at 631.

[21] See also MacPherson v European Strategic Bureau Ltd [2000] EWCA Civ 248; Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 243–244.

[22] Section 829(1) of the Companies Act 2006.

[23] Section 829(2) of the Companies Act 2006.

[24] § 170 AktG; § 264 HGB.

[25] § 158(1) AktG; §§ 275(2) Nr. 20 and 275(3) Nr. 19 HGB.

[26] § 58(2) AktG.

[27] See especially §§ 58(2a) and 58(3) AktG.

[28] § 172 AktG.

[29] § 119(1) AktG. See also § 174(1) AktG.

[30] AktG § 174(1) AktG.

[31] See also Roth GH, Die (Ohn-)Macht der Hauptversammlung. Oder: Unlautere Werbung für Aktienrecht, ZIP 2003 pp 370–371. The wording of the German Corporate Governance Code is slightly misleading in this respect. See section 2.2.1 of the Code: "The Management Board submits to the General Meeting the Annual Financial Statements and the Consolidated Financial Statements. The General Meeting resolves on the appropriation of net income …"

silent on who may declare a dividend and thus does not require the dividend to be declared by shareholders in general meeting. The model articles which apply as default articles of association for public companies (Table A) distinguish between final dividends and interim dividends. (a) According to Table A, "the company may by ordinary resolution declare dividends in accordance with the respective rights of the members, but no dividend shall exceed the amount recommended by the directors".[32] (b) On the other hand, interim dividends may normally be paid by the directors from time to time.[33] Before declaring an interim dividend, the directors must satisfy themselves that the financial position of the company warrants the payment of such a dividend out of profits available for distribution.[34] Where the power to pay interim dividends is vested in the board of directors, shareholders in general meeting cannot interfere with the directors' exercise of this power.

Sanctions. The Second Directive further provides that any distribution made contrary to such rules must be returned by shareholders who have received it if the company proves that these shareholders knew of the irregularity of the distributions made to them, or could not in view of the circumstances have been unaware of it.[35] The threshold is quite high. In practice, it is difficult to recover improperly made distributions from shareholders. However, even this is a minimum requirement.[36] Shareholder liability is typically complemented by the personal liability of board members for breach of duty of care or otherwise.[37]

Intra-group transfers. Intra-group payments and asset transfers are not treated differently under the Second Directive. There is therefore a risk that dividend payments in excess of distributable assets, unusual transactions, the sale of assets at an undervalue, or the purchase of assets at an overvalue, are regarded as a breach of the mandatory provisions of company law.

10.2.3 Redemption of the Subscribed Capital

The company can also make payments to shareholders through redemption of the subscribed capital without reducing the subscribed capital. The redemption of subscribed capital can be an alternative to the payment of dividends for tax reasons. For public limited-liability companies, the most important legal constraints are again based on the Second Directive and contain the following:[38]

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[32] Table A, regulation 102.

[33] Table A, regulation 103.

[34] Table A, regulation 103.

[35] Article 16 of Directive 77/91/EEC (Second Company Law Directive).

[36] Schwarz GC, Europäisches Gesellschaftsrecht. Nomos, Baden-Baden (2000) p 380. For German law, see § 62 AktG.

[37] For German law, see §§ 62 and 117 AktG (shareholder liability) and § 93(3) AktG (liability of board members). For English law, see section 171 of the Companies Act 2006 (duty to act within powers) as well as section 847 (consequences of unlawful distribution). See also Re Exchange Banking Co, Flitcroft's Case (1882) 21 Ch D 519; Bairstow v Queen's Moat Houses [2001] 2 BCLC 531; It's A Wrap (UK) Ltd v Gula [2006] EWCA Civ 544.

[38] Article 35, 38 and 40 of Directive 77/91/EEC (Second Company Law Directive).

- Member States have a right but not a duty to authorise the redemption of the subscribed capital without its reduction.
- If they do, the conditions set out in Article 35 of the Second Company Law Directive must be complied with.
- The conditions depend on whether the articles of association provide for redemption or not. If they do, the redemption must be decided on by the general meeting voting at least under the usual conditions of quorum and majority. If they do not provide for redemption, redemption must be decided on by the general meeting acting at least under special conditions of quorum and majority.[39] In both cases, there must be a separate vote for each class of shareholders whose rights are affected by the transaction.[40]
- Only sums which are available for distribution may be used for redemption purposes.[41]

10.2.4 Share Buy-backs

Especially in listed companies, share buy-backs are a popular way to return funds to shareholders. Share buy-backs can be in the interests of both the firm and its long-term and short-term shareholders.

First, share buy-backs are a way to manage the debt-to-equity ratio (section 5.5). Share buy-backs increase leverage.

Second, share buy-backs can increase share price in the short term by increasing demand or otherwise. An increase in share price at least in the short term is in the interests of activist short-term shareholders such as hedge funds. Hedge funds and other vocal shareholders often try to force the company to increase share price through share buy-back programmes and special dividends.

Third, share buy-backs can help to stabilise share price. Less volatility, a stable increase in the share price, and lower perceived risk can mean that investors are prepared to pay more for shares. This can reduce the firm's funding costs in the long term.

Fourth, share buy-backs reduce the amount of assets that can be distributed to shareholders and can therefore function as a takeover defence. It is more difficult and more expensive to refinance an LBO, if there are hardly any assets that the target company can distribute to its new owners after a takeover.

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[39] Article 40(1) of Directive 77/91/EEC (Second Company Law Directive): "The laws of the Member States shall provide that the decisions referred to in Articles 29 (4) and (5), 30, 31, 35 and 38 must be taken at least by a majority of not less than two-thirds of the votes attaching to the securities or the subscribed capital represented." Article 40(2): "The laws of the Member States may, however, lay down that a simple majority of the votes specified in paragraph 1 is sufficient when at least half the subscribed capital is represented."

[40] Article 38 of Directive 77/91/EEC (Second Company Law Directive).

[41] See Article 15(1) of Directive 77/91/EEC (Second Company Law Directive).

Fifth, subject to the principle of equivalent treatment of shareholders, share buy-backs can change the shareholder base of the company.

Legal aspects. Share buy-backs raise many legal questions. (a) As share buy-backs are a way to return funds to shareholders, it is necessary to protect the interests of creditors. (b) In addition, the equivalent treatment of shareholders can be an issue. There is a risk that the company decides to pay too much for the shares of a controlling shareholder, or that share buy-backs are used as a means to withdraw the shares of minority or unwanted shareholders. (c) Furthermore, when a listed company buys back its own shares, it must take into account provisions that prohibit the abuse of inside information and market manipulation.

For those reasons, share buy-backs have been regulated through provisions of EU company and securities markets law. That regime applies only to public limited-liability companies (such as the AG, SA, plc, SE). However, Member States' national company laws tend to contain rules on share buy-backs for private limited-liability companies (such as the GmbH, S.A.R.L., ltd).

Share buy-backs by companies whose shares have been admitted to trading on a regulated market are subject to further constraints. In the EU, they are based in particular on the Directive on market abuse. Member States' national laws and stock exchange rules may contain further restrictions.[42]

Share buy-backs, reduction in capital, subscription for shares. Share buy-backs can be distinguished from reductions in legal capital. Share buy-backs can basically be carried out in two ways: by reducing the company's legal capital or without doing so.[43] A decision to reduce the company's legal capital is subject to its own rules.[44]

Share buy-backs can also be distinguished from subscriptions for the company's own shares. Whereas the former can be permitted on certain terms, the latter are prohibited under the Second Company Law Directive.[45]

Attribution. The provisions of the Second Directive that apply to the acquisition of own shares are not very effective in preventing circumvention.

The main rule applies only to the company itself and to a person acting in his own name but on the company's behalf. It does not apply to a subsidiary acting in its own name and on its own behalf. Furthermore, the company itself is, in effect, not prohibited from giving financial assistance with a view to the acquisition of its shares by a third party, but the company may give financial assistance only on certain conditions.[46]

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[42] For English law, see section 723 of the Companies 2006, Chapter 12 of the Listing Rules (LR 12), and section 118A(5)(b) of FSMA 2000: "Behaviour does not amount to market abuse for the purposes of this Act if … (b) it conforms with the relevant provisions of Commission Regulation (EC) No 2273/2003 …"

[43] See Article 20(1) of Directive 77/91/EEC (Second Company Law Directive).

[44] Article 30 of Directive 77/91/EEC (Second Company Law Directive).

[45] Article 18 of Directive 77/91/EEC (Second Company Law Directive). For German law, see § 56 AktG.

[46] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive) as amended by Article 1(6) of Directive 2006/68/EC.

Prohibited and permitted share buy-backs. The main rule under the Second Directive is that the company may not acquire its own shares. Member States' laws may nevertheless permit the acquisition of own shares on certain conditions. Member States have a right but not a duty to permit the acquisition of own shares.[47]

Distributable assets, equivalent treatment. The Second Directive only permits the company to acquire its own shares within the limits of its distributable assets, unless the company reduces its legal capital.[48]

Both the Second Directive and the Transparency Directive provide for the equal treatment of all holders of shares who are in the same position.[49]

Decision-making. There must be a prior resolution by the general meeting to authorise the board to decide on share buy-backs. The general meeting thus has a veto right intended to ensure that share buy-backs do not benefit a certain block of shareholders to the detriment of other shareholders.

The authorisation must determine the terms and conditions of such acquisitions.[50] In particular, the authorisation must contain the maximum number of shares to be acquired, the duration of the period for which the authorisation is given, and the maximum and minimum consideration. The duration of the period for which the authorisation is given is determined by national law but may not exceed five years after amendments made in 2006.

Those rules are complemented by the rule that prevents the company from using voting rights attaching to its own shares.[51]

Disclosure. Information about share buy-backs must be disclosed to shareholders in many ways. Shareholders are entitled to information before the general meeting authorising the share buy-backs.[52] Disclosure to the general meeting is complemented by ad-hoc disclosure under the Directive on market abuse[53] as well as by regular disclosure obligations. According to the Second Directive, the annual report must contain detailed information about share buy-backs.[54]

Maximum number of shares to be acquired. The maximum number of shares to be acquired by the company is constrained in four basic ways under the Second Directive. First, the authorisation must set out the maximum number of shares to be acquired. Second, only fully paid-up shares may be included in the transaction. Third, the acquisitions, including previous acquisitions, can only be financed with assets that can be distributed to shareholders under the Second Directive. Fourth, Member States may subject acquisitions to the condition that "the nominal value

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[47] Article 19(1) of Directive 77/91/EEC (Second Company Law Directive).

[48] Article 15 of Directive 77/91/EEC (Second Company Law Directive).

[49] Articles 19(1) and 42 of Directive 77/91/EEC (Second Company Law Directive); Article 17(1) of Directive 2004/109/EC (Transparency Directive).

[50] Article 19(1) of Directive 77/91/EEC (Second Company Law Directive) as amended by Article 1(4) of Directive 2006/68/EC.

[51] Article 22(1) of Directive 77/91/EEC (Second Company Law Directive).

[52] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive) as amended by Article 1(6) of Directive 2006/68/EC.

[53] Article 6(1) of Directive 2003/6/EC (Directive on market abuse).

[54] See Article 22(2) of Directive 77/91/EEC (Second Company Law Directive).

or, in the absence thereof, the accountable par of the acquired shares, including shares previously acquired by the company and held by it … may not exceed a limit to be determined by Member States. This limit may not be lower than 10% of the subscribed capital".

Other terms. There also other constraints on the terms of the acquisition. The transactions must take place "at fair market conditions" (especially with regard to interest received by the company and security provided to the company). The credit standing of the third party or each counterparty must have been "duly investigated".[55] Furthermore, where a third party, by means of financial assistance from a company, acquires that company's own shares, the acquisition shall be made "at a fair price".[56]

Market abuse. The acquisition of shares must not constitute insider trading[57] or market manipulation.[58] If the general prohibitions in the Directive on market abuse were applied according to their wording, they would seem to prohibit even share buy-backs and the stabilisation of the share price. However, share buy-backs and the stabilisation of share price are sometimes regarded as acceptable forms of market behaviour and permitted on certain conditions under Article 8 of the Market Abuse Directive. The rules that the firm should comply with can be found in Regulation 2273/2003 complementing the Directive. Stock exchange rules can provide for more detailed rules on the execution of the buy-back programme.

In the US, Rule 10b-18 under the Securities Exchange Act of 1934 provides issuers with a qualified safe harbour from liability for market manipulation when they repurchase their common stock in accordance with the rule's timing, price, manner of purchase and volume conditions. The SEC has emphasised that failure to satisfy the safe harbour's conditions does not give rise to any presumption that the repurchases are manipulative.[59]

Disposal of shares. The Second Directive both permits the company to keep part of its shares and requires it to dispose of its own shares in some cases. Depending on the governing law, a public company may hold at least 10% of its subscribed capital.[60] For example, an English company listed in England has a limited right to own "treasury shares".[61]

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[55] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive) as amended by Article 1(6) of Directive 2006/68/EC.

[56] Articles 23(1) of Directive 77/91/EEC (Second Company Law Directive) as amended by Article 1(6) of Directive 2006/68/EC.

[57] Articles 3 and 4 of Directive 2003/6/EC (Directive on market abuse).

[58] Article 19(1) of Directive 77/91/EEC (Second Company Law Directive); Articles 3 and 4 (insider trading) and 5 (market manipulation) of Directive 2003/6/EC (Directive on market abuse).

[59] See Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice. New York City (2008) pp 157–158.

[60] Article 20(2) of Directive 77/91/EEC (Second Company Law Directive).

[61] See Morse G, The Introduction of Treasury Shares into English Law and Practice, JBL (2004) pp 303–331.

If the acquisition was not lawful, the shares must be disposed of within one year.[62] In some exceptional cases, the company may acquire its shares but has to dispose of them or cancel them within not more than three years of their acquisition.[63]

It is normal for the company to cancel shares. In fact, many of the core objectives of share buy-back programmes would not be achieved otherwise.

Pre-emption rights. Although not required by the Second Directive,[64] existing shareholders can have pre-emption rights under the laws of some Member States when the company disposes of its shares otherwise than by cancelling them. In this case, the decision to sell those shares must be preceded by a decision to waive pre-emption rights. This is a further factor that makes it easier in many countries to cancel shares rather than sell them.

Mandatory bid. If the company cancels shares, each remaining shareholder will end up holding a slightly larger percentage of the company's shares. If the company acquires its own shares, each remaining shareholder will have a slightly larger percentage of votes, as the right to vote attaching to the company's own shares must be suspended.[65] If the firm has a large shareholder, both situations can mean that a threshold that will trigger an obligation to make a mandatory bid will be reached.[66]

Usual ways to mitigate this risk include: the sale of shares by that shareholder; the issuing of new shares that will not be subscribed for by that shareholder; and prior approval by the supervisory authority.

However, the obligation to make a mandatory bid might be triggered under the provisions of Member States' national laws, if they are more stringent than those of the Directive on takeover bids.[67] According to the wording of the Directive, the duty to make a mandatory bid will only be triggered where a person holds securities giving him/her a specified percentage of voting rights in the company "as a result of his/her own acquisition or the acquisition by persons acting in concert with him/her".[68] This is arguably not the case where that threshold is reached as a result of share buy-backs or the cancelling of shares.

Summary: Community provisions impose limits on the company's right to acquire its own shares. Constraints based on Community law apply to public limited-liability companies in general, and to companies whose shares have been admitted to trading on a regulated market in the EU. Similar constraints can apply to private limited-liability companies under the national provisions of Member States' laws. The main constraints based on Community law can be summarised as follows:

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[62] Article 21 of Directive 77/91/EEC (Second Company Law Directive).

[63] Article 20 of Directive 77/91/EEC (Second Company Law Directive).

[64] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).

[65] Article 22(1) of Directive 77/91/EEC (Second Company Law Directive).

[66] See, for example, Stattin D, Dispenser från budplikt vid Volkswagens köp av Scania-aktier, JT 2007–08 pp 873–881.

[67] Article 3(2)(b) of Directive 2004/25/EC (Directive on takeover bids).

[68] Article 5(1) of Directive 2004/25/EC (Directive on takeover bids).

- Member States have a right but not a duty to permit the acquisition of own shares.
- The acquisition of own shares requires a resolution by the general meeting authorising the acquisition. The authorisation must determine the terms and conditions of acquisitions.
- Members of the board are required to satisfy themselves that those conditions are respected at the time when each authorised acquisition is effected.
- There are limits on the number of shares that the company may acquire.
- The acquisition of shares must not constitute insider trading or market manipulation. In order to comply with provisions based on the Directive on market abuse, a company whose shares have been admitted to trading on a regulated market must use a buy-back programme that complies with the detailed terms of Community legislation implementing the provisions of the Market Abuse Directive. Those terms have been set out it in Regulation 2273/2003.

10.2.5 Redeemable Shares

Depending on the jurisdiction and the company, shares may be issued as redeemable at the option of the company or the shareholder, or on a certain date. The redemption of shares involves a repayment by the company to the shareholder of the capital subscribed for the shares, in return for which the shares are cancelled. This is one method of reducing the capital of the company.

Venture capital. Redeemable shares can be useful in venture capital. Parties to a venture capital transaction know that the venture capital firm prefers to exit the target after, perhaps, five years. The use of redeemable shares can help to mitigate risk for the venture capital firm. For example, redeemable shares can make it easier for the venture capital firm to cash out where the target is not yet ready for an IPO but has distributable assets.

Circumvention of equivalent treatment. There can be other company law reasons to use redeemable shares. Whereas share buy-backs are generally constrained by the principle of equivalent treatment of all holders of shares who are in the same position,[69] the use of redeemable shares can provide an alternative way to exit the company without infringing that principle, because the holders of redeemable shares and holders of other shares are not in the same position.

Tax. The use of redeemable shares can bring tax benefits depending on the jurisdiction. Whereas the distribution of profits typically has tax implications, returning shareholders' capital to shareholders typically is not regarded as the distribution of profits.

Different forms. There can be many different kinds of redeemable shares. One of the more extreme forms of redeemable shares is a zero-dividend preference share with a fixed redemption date.

[69] Article 42 of Directive 77/91/EEC (Second Company Law Directive) and Article 13(1) of the Transparency Directive.

Core provisions. The Second Company Law Directive sets out the core rules on redeemable shares for public limited-liability companies:[70]

- Member States have a right but not a duty to permit the issuing of redeemable shares.
- If they do, the conditions set out in Article 39 of the Second Company Law Directive must be complied with.
- In particular, redemption must be authorised by the company's statutes or instrument of incorporation before the redeemable shares are subscribed for.
- The shares must be fully paid up.
- The terms and the manner of redemption must be laid down in the company's statutes or instrument of incorporation.
- Redemption can be only effected by using sums available for distribution to shareholders or the proceeds of a new issue made with a view to effecting such redemption.
- An amount equal to the nominal value or, in the absence thereof, to the accountable par of all the redeemed shares must be included in a reserve which cannot be distributed to shareholders. It may be used only for the purpose of increasing the subscribed capital by the capitalisation of reserves. However, that constraint will not apply, where a new issue is made for the purpose of effecting the redemption and the redemption is effected by using the proceeds of the new issue. Furthermore, funds can be distributed to shareholders in the event of a reduction in the subscribed capital.

Case: Scania. The use of redeemable shares can be illustrated by the case of Scania AB, a Swedish manufacturing company.

In 2008, Scania used redeemable shares for tax reasons as follows: (1) Instead of making dividend payments from unrestricted equity, Scania distributed funds to shareholders from unrestricted equity through the withdrawal of redemption shares. (2) Scania had A shares and B shares. The Annual General Meeting (AGM) held on 5 May 2008 approved a dividend of SEK 5.00 per share. (3) The AGM also approved the implementation of a 2:1 split. As a result of the split, each share was thus being divided into two shares of its original class (A or B). (4) The reason for implementing the split was that one of the new shares was to be redeemed through a mandatory withdrawal. The shares to be redeemed were those labelled as redemption shares. (5) An amount of SEK 7.50 was paid to shareholders for each redemption share, of which SEK 1.25 was transferred from share capital. SEK 6.25 constituted a premium and was transferred from unrestricted equity. (6) This meant that share capital was reduced from SEK 2 billion to SEK 1 billion. (7) However, a simultaneous bonus issue approved by the general meeting restored restricted equity and share capital to their original levels before the reduction in share capital. The bonus issue thus increased the company's share capital from SEK 1 billion to SEK 2 billion. The capital that was used to increase the share capital was transferred from unrestricted equity. No new shares were issued.

[70] Article 39 of Directive 77/91/EEC (Second Company Law Directive).

10.2.6 Withdrawal of Shares Otherwise

It would be legally more difficult to withdraw shares unless it is done following a share buy-back or through the use of redeemable shares. For public limited-liability companies, the most important legal constraints are based on the Second Company Law Directive:[71]

- Member States have a right but not a duty to authorise the reduction of subscribed capital by compulsory withdrawal of shares.
- If they do, the conditions set out in Article 36 of the Second Company Law Directive must be complied with.
- Compulsory withdrawal must always be prescribed or authorised by the articles of association before subscription of the shares which are to be withdrawn.
- Where the compulsory withdrawal is merely authorised by the articles of association, it shall be decided upon by the general meeting unless it has been unanimously approved by the shareholders concerned. There are no special requirements as to quorum and majority under Community law.[72]
- Where the compulsory withdrawal is prescribed by the articles of association, the internal distribution of power is determined by the provisions of national company law. The company body deciding on the compulsory withdrawal will fix the terms and modalities of the withdrawal to the extent that they have not already been fixed through the articles of association.
- The creditor protection provisions set out in the Second Directive will usually apply.[73]

10.3 Third Party as a Source of Remuneration

10.3.1 Introduction

A shareholder can release capital that he has invested in the company by selling shares to a third party. A shareholder can sell shares for cash. Alternatively, the third party can offer to pay for the shares by issuing its own shares to the shareholder.

Cash. The sale can be transacted at a stock exchange or otherwise, and it can be a private sale or a public offering. For many investors such as private equity sponsors, obtaining a clean exit on favourable terms is an absolute requirement.

Sometimes the sale of shares for cash is not free or not voluntary. The shareholders may have agreed on how the shares can be bought or sold. This is particularly important in family-owned companies and companies with few shareholders

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[71] Articles 35–40 of Directive 77/91/EEC (Second Company Law Directive).

[72] Compare Articles 40 and 38 of Directive 77/91/EEC (Second Company Law Directive).

[73] See Articles 36(1)(d) and 32 of Directive 77/91/EEC (Second Company Law Directive) replaced by Article 1(9) of Directive 2006/68/EC.

or few controlling shareholders. Joint-ventures typically raise difficult questions of exit. In some cases the sale of shares to a third party is based on mandatory provisions of law (squeeze-out right, sell-out right).

Conversion of shares, consideration other than in cash. Instead of a clean exit, the buyer may offer a share exchange. Share exchanges are common in corporate takeovers and in public takeover bids.

Mergers and divisions. Usually, the target company will, at least in the short-term, survive the exit of the shareholder. Formal mergers and divisions provide a particular form of exit. Depending on the role of the company, the company will either survive the transaction or expire.

In a merger, shareholders of a non-surviving company can receive consideration in cash and/or consideration other than in cash. Typically, non-cash consideration consists of shares in a participating company that will survive the merger. Divisions are governed by roughly similar rules.

Business acquisitions. Business acquisitions can be effected through the sale of a substantial number of shares issued by the company. Business acquisitions tend to raise most questions of corporate finance law simultaneously. For this reason, business acquisitions will be discussed in detail in Chapters 11–20 of this book.

10.3.2 Clean Exit, Private Sale, Auction, IPO, Bids

General Remarks

The sale of existing shares for cash is one of the most common forms of exit. The shares of privately-owned companies can be sold and bought *privately*. A particular form of private sale is sale through *auction*. Even an IPO or another form of *public offering* can be used. Whereas an IPO is initiated by the seller, a public takeover bid is initiated by the buyer.

In Anglo-American jurisdictions, disclosure of information to shareholders and freedom to sell shares have been the two most important traditional corporate governance tools relied on by investors in listed companies.

Transferability. The sale of shares is made easier by the transferability of shares. Shares that are admitted to trading on a regulated market must be freely negotiable. There can be restrictions on the sale of shares in privately-owned companies depending on the company form (see Chapter 18 on takeover defences).

Spin-offs, divisions. The sale of shares can be preceded by incorporation in connection with a spin-off or a division (section 10.4.4).

Sole owner. A sole shareholder such as a private-equity firm can exit the firm in different ways.

The traditional way for a private-equity firm to cash in the investment is through a trade sale, a management buy-out, or an initial public offering (IPO).

Sometimes they can nevertheless be difficult to arrange (adverse market conditions), and it can be equally difficult for other private-equity firms to find new companies to buy (excess liquidity in the market). It is therefore not uncommon

for private-equity firms to sell their holdings to a competitor. Secondary or even tertiary buy-outs can be an alternative to an IPO or a trade sale.

Private sale, trade sale, governing law, caveat emptor. In a private sale, the most important questions that the shareholder will need to address include: the price; responsibility for the quality of the shares; and information. Information will influence the price that the buyer will be prepared to pay for the shares, the terms on the responsibility of the seller for the quality of the shares, and the distribution of risk between the parties generally. A private sale of shares can enable the parties to combine a high level of financial and legal due diligence by prospective purchasers with a high level of vendor due diligence.

The private sale of shares raises many legal questions (which will be discussd in Chapters 10–11 in more detail). (a) The transaction can be structured in different ways. There is an important distinction between private sales between two parties and auction sales. (b) The initiator of the sale can choose the acquisition process. There is a typical acquisition process consisting of a typical order of events and documents (preliminary agreements, due diligence, drafting of acquisition agreements, signing, disclosure, closing). (c) The acquisition agreements contain typical terms on disclosure, warranties and indemnities. (d) Consideration for shares or assets can be structured in different ways. (e) The general structure of the transaction and the way consideration is structured influence the form of acquisition finance.

The law governing the contractual obligations between the parties is determined by the Rome I Regulation.[74] In the absence of choice, the governing law would usually be that of the seller's home country.[75] However, depending on the circumstances, the parties may be deemed to have chosen the law of another country,[76] or the contract as a whole may be deemed to be most closely connected with another country.[77] In practice, many connecting factors link the contract with the country in which the company is incorporated. In order to avoid uncertainty, the parties virtually always choose the governing law.

The private sale of shares will be governed by the national provisions of law applicable to the sale of goods or the sale of rights. It will not be governed by the provisions of the CISG.

The sale of shares will not be governed by the CISG, because the CISG does not apply to sales "of stocks, shares, investment securities, negotiable instruments or money".[78] Neither does it apply to sales "by auction".[79]

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[74] See Articles 24(1) and 28 of Regulation 593/2008 (Rome I). The 1955 Hague Convention on the Law Applicable to International Sale of Goods does not apply to "sales of securities". Article 1(2) of the Convention.

[75] See Article 4(2) of Regulation 593/2008 (Rome I).

[76] Article 3(1) of Regulation 593/2008 (Rome I).

[77] Articles 4(3) and 4(4) of Regulation 593/2008 (Rome I).

[78] CISG Article 2(d).

[79] CISG Article 2(b).

The main rule on the liability of the seller for the quality of shares is caveat emptor (buyer beware) combined with the prohibition of fraud (section 16.2). On the other hand, the seller can often be deemed to have agreed that the company, its business, or the shares will be compatible with information disclosed by the seller. For this reason, it is in the interests of both parties to agree on the disclosure of information, the liability of the seller for information, and the liability of the seller for the quality of the company, its business and the shares.

Initial public offering (IPO) by the seller. An IPO represents an alternative to a private sale. The use of an IPO depends on the preferences of market investors.

An IPO can be structured in many ways. (a) In a clean exit, a large shareholder offers to sell all shares that he owns for cash. (b) The shareholder may prefer to keep part of his holdings in order to signal the quality of shares; the potential buyers' perceived risk might be reduced if the buyers believed that the interests of the seller have been sufficiently aligned with those of their own. (c) Partly for the same reason and partly for the purpose of raising new capital, the firm might issue new shares and offer them to the public at the same time as a shareholder offers existing shares to the public. Potential investors might believe that their interests have partly been aligned with those of the firm itself, because the firm will require funding in the future and a decline in the value of the share after the IPO would damage the firm's reputation, increase perceived risk, and make it more expensive for the firm to raise equity funding in the future. (d) The shareholder might also decide to keep a substantial part of his shares. For example, the controlling shareholder might prefer to change the nature of his holdings from illiquid to more liquid and obtain a market valuation for the shares by floating part of them on a regulated market.

Controlling shareholders may sometimes be able to choose between the IPO of the firm and the sale of its assets. For example, an IPO is a way for a private-equity group to realise the value of its goodwill; the group would not be able to realise it just by divesting its portfolio companies.

Public offering by the seller. Where the shares have already been admitted to trading on a regulated market, a large shareholder can make an offering to the public for the sale of shares.

Public takeover offer. The public offer can be made by the buyer rather than a shareholder contemplating the sale of his shares.

The Directive on takeover bids applies to takeover bids for the securities of a company governed by the laws of a Member State where all or some of those securities are admitted to trading on a regulated market.[80]

Sell-out rights, squeeze-out rights. The existence of sell-out rights and squeeze-out rights can make the sale or purchase of shares compulsory at the insistence of the buyer (squeeze-out right) or the seller (sell-out right). The Directive on takeover bids provides for limited squeeze-out rights and sell-out rights following a public takeover bid.[81]

[80] Articles 1(1) and 2(1)(a) of Directive 2004/25/EC (Directive on takeover bids).

[81] Articles 15 and 16 of Directive 2004/25/EC (Directive on takeover bids).

The question of valuation of shares raises particular questions in involuntary transactions such as squeeze-out situations. The minimum price payable under the Directive on takeover bids is the “fair price”, and similar requirements can be found in Member States’ laws. The method of defining “fair price” or the minimum price payable to an involuntary seller can depend on the governing law and the context (see section 5.11.7).

Mergers, divisions. A merger or a division can provide for a way to obtain cash for shares or to change the nature of a shareholder’s holdings. In both cases, the consideration can consist of shares, other securities, or cash (section 10.4 below).

Termination of a joint-venture. The termination of a joint-venture raises legal problems, particularly where one party wants to remove the other party and take over the whole project.

Auctions

Trading on a stock exchange involves the use of auction mechanisms. Auctions can also be used in private sales and in offerings made to the public.

Auctions have increasingly been used by private equity sponsors and trade sellers instead of an IPO. On the other hand, even where the seller chooses an IPO, the pricing method can involve the use of an auction process. It is also possible to combine an IPO process with an auction process (a dual-track process).

From a legal perspective, auctions can be mandatory in some cases, one of the options available under the applicable laws in other cases, or at least a way to signal compliance with the seller’s or its representatives’ duty of care. The Delaware case of *Smith v. Van Gorkom* is an example of how an auction could have mitigated the risk exposure of the seller’s board members.[82]

Auction forms in economics. In economic theory, an auction is a game in which (i) buyers make “bids” for the good, on the basis of which (ii) the good is allocated to (at most) one of the buyers, and (iii) buyers make payments (which can in principle be negative) to the seller.[83]

Auctions are used when there is a monopoly on one side of the market and the organiser of the auction has the ability to commit himself in advance to a set of policies. This commitment can induce bidders to bid in desirable ways. According to auction theory, the reason a monopolist chooses to sell by auction is that he does not know the bidders’ valuations.[84]

There are various forms of auctions. The basic commercial auction types are: the ascending-bid auction (the English auction); the descending-bid auction (the

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[82] Smith v. Van Gorkom or the Trans Union case, 488 A.2d 858 (Supreme Court of Delaware, 1985).

[83] Generally, see Milgrom P, Putting Auction Theory to Work. Cam U P, Cambridge (2004); Maskin E, The Unity of Auction Theory: Milgrom’s Masterclass, J Econ Lit 42 (2004) pp 1102–1115.

[84] McAfee RP, McMillan J, Auctions and Bidding, J Econ Lit 25 (1987) p 704.

Dutch auction); the first-price sealed-bid auction; and the second price sealed-bid auction (the Vickrey auction).[85]

The first-price sealed-bid price auction[86] means that all bidders simultaneously submit bids so that no bidder knows the bid of any other participant. The highest bidder pays the price that it submitted.

In an English auction, participants bid openly against one another, with each bid being higher than the previous bid. The auction ends when no participant is willing to bid further. The highest bidder pays the price.

The second-price sealed-bid auction is also known as the Vickrey auction after William Vickrey (Nobel Price in Economics in 1996).[87] In the Vickrey auction, the winner is the highest bidder, but the winner pays the second-highest bid rather than the winner's own bid. The Vickrey auction makes it easier for the seller to obtain information about the highest price that a bidder is willing to pay. Interestingly, Johann Wolfgang von Goethe used a similar auction mechanism already in 1797.[88] Ebay is one of the best-known users of the Vickrey auction.

The Dutch auction means that the auctioneer begins with a high asking price. The asking is lowered until some participant is willing to accept the auctioneer's price, or a predetermined minimum price is reached. The winning participant pays the last announced price.[89]

Although there are various auction mechanisms, Vickrey found out that auction meachanisms are revenue equivalent assuming complete information. This means that they are – at least in principle – expected to result in the same expected revenue for the vendor.

Reserve price. The seller may set a reserve price. If the auction fails to have a bid equal to or higher than the reserve, the item remains unsold. If there is no reserve price, the auction is called absolute.

Trading on a stock exchange. Trading on a stock exchange involves the use of auction mechanisms. For example, trading on the NYSE involves the use of two

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[85] Generally, see Paul Klemperer, Auctions: Theory and Practice. Princeton U P (2004); McAfee RP, McMillan J, Auctions and Bidding, J Econ Lit 25 (1987) pp 699–738.

[86] Also known as sealed high-bid auction or first-price sealed-bid auction (FPSB).

[87] See Maskin E, The Unity of Auction Theory: Milgrom's Masterclass, J Econ Lit 42 (2004) p 1105.

[88] Johann Wolfgang von Goethe wanted to sell rights to his manuscript Herrmann und Dorothea to his publisher Hans Friedrich Vieweg by using an auction mechanism. This is how Goethe described the auction mechanism to Hans Friedrich Vieweg in a letter dated 16 January 1797: "Was das Honorar betrifft, so stelle ich Herrn Oberkonsistorialrat Böttiger ein versiegeltes Billet zu, worin meine Forderung enthalten ist, und erwarte, was Herr Vieweg mir für meine Arbeit anbieten zu können glaubt. Ist sein Anerbieten geringer als meine Forderung, so nehme ich meinen versiegelten Zettel uneröffnet zurück und die Negation zerschlägt sich, ist es höher, so verlange ich nicht mehr als in dem, alsdann von Herrn Oberkonsistorialrat zu eröffnenden Zettel verzeichnet ist." See Fehr B, Von Goethe erdacht, von Ebay genutzt: Zweitpreis-Auktionen, FAZ, 22 December 2007 p 21.

[89] See, for example, section 5.1.5 of Annex I of the Guideline of the European Central Bank of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7) (as amended).

different trading mechanisms, with a call auction used to open trading and a continuous auction used throughout the trading day. In a call auction, orders accumulate and the specialist sets a single market-clearing price at which all executed orders transact. In a continuous auction, the specialist quotes bid and ask prices and trades occur individually.[90]

In the EU, the regulation of trading mechanisms is based on the MiFID. The MiFID covers the activities of "regulated markets" and "multilateral trading facilities" (MTF), among other things.[91] Both bring together or facilitate the bringing together of multiple third-party buying and selling interests in financial instruments in a way that results in a contract.

At a general level, the MiFID lays down pre-trade transparency requirements. Investment firms and market operators operating an MTF or a regulated market must make public current bid and offer prices and the depth of trading interests at these prices on reasonable commercial terms and on a continuous basis during normal trading hours.[92]

Again at a general level, Regulation 1287/2006[93] specifies the types of trading systems and contains a summary of information to be made public depending on the type of system. There are four types of trading systems: the continuous auction order book trading system; the quote-driven trading system; the periodic auction trading system; and other trading systems.[94]

Private auction. There are different ways to structure a private auction. Typically, the contents of the process will be disclosed to potential bidders in a process letter. An information memorandum will be distributed to interested parties that have undertaken confidentiality obligations. The seller and its advisers usually limit the potential liability that may arise in the distribution of the information memorandum. Interested parties will be able to engage in limited due diligence at least by verifying the contents of the information memorandum in a data room. In addition to the information memorandum, a draft contract will typically be sent to prospective bidders. Interested bidders will submit their bids, together with any comments on the draft contract. A closed auction often has more than one round and may involve simultaneous negotiations with more than one bidder. As a rule, the sale agreement that will be drafted by the parties will contain the same terms as a privately negotiated agreement between two parties (Chapter 16).

The sale of Jaguar and Land Rover is a recent example of a private auction. In 2007, Ford gave three banks a mandate to sell Jaguar and Land Rover, its two British luxury brands. In

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[90] O'Hara M, Market microstructure theory. Blackwell, Cambridge (1995).

[91] For the definition of a "regulated market", see Article 4(1)(14) of Directive 2004/39/EC (MiFID). For the definition of a "multilateral trading facility" (MTF), see Article 4(1)(15).

[92] Articles 29(1) and 44(1) of Directive 2004/39/EC (MiFID).

[93] Regulation 1287/2006 implementing Directive 2004/39/EC as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive.

[94] For the definition of these four systems, see ANNEX II, Table 1 of Regulation 1287/2006.

June 2007, a small group of prospective bidders that had showed interest received limited financial data on the two brands. In July 2007, Ford received indicative bids which kicked off the auction. In August 2007, Ford let the prospective bidders begin due diligence. The successful bidder was expected to sign an estimated 40 contracts as part of the takeover, ranging from engine production to the operation of information technology systems. In order not to alienate other bidders in case negotiations with the favoured candidate fell through, Ford could have selected a preferred bidder without making any official announcement. In January 2008, Ford nevertheless stated that it was committed to focused negotiations at a more detailed level with Tata Motors. Tata had a period of exclusivity to secure an agreement. After complicated negotiations, a final arrangement was reached in March 2008.

A private auction is based on contracts. The relationship of prospective bidders with the seller, and the relationship of the parties with the auctioneer, if any, falls within the scope of the Rome I Regulation. The choice of law principle of lex loci contractus is regarded as the most appropriate for auctions. In the absence of choice, a presumption under the Rome I Regulation would lead to the application of lex loci contractus as the governing law.[95]

The 1955 Hague Convention on the Law Applicable to International Sales of Goods, which, as its name implies, does not apply to the sale of shares, contains a special rule for sales at auctions and the stock exchange. In the absence of choice, those sales will be governed by the law of the country where the auction or stock exchange is situated, that is, the lex loci contractus. Some of the Member States of the EU and Contracting States to the Rome Convention are parties to the Hague Convention.[96]

Dutch auction IPO. The Dutch auction has exceptionally been used in IPOs instead of the bookbuilding pricing method (section 5.10.2).

In the US, a committee appointed by the SEC suggested that the Dutch auction could be used as an alternative to the bookbuilding method (Dutch auction IPO) according to the following principles:[97] Prospective investors bid on their preferred number and price of shares. Successful bids are determined by starting with the highest price and then moving downward until investor demand equals the total amount of securities offered, or clearing price. All shares are awarded at the same final offering price. Excess demand results in a pro rata distribution of shares.

The unconventional Dutch auction was used by Google in its IPO in 2004. In the Google IPO, only qualified investors could bid for the shares. Prospective investors had to register in order to obtain a bidder ID and have an account with one of the 28 securities firms underwriting the sale. Qualified investors were asked to specify both the price they were willing to pay and the number of shares they wanted. After this, shares were allocated beginning with the highest-priced bids. The price offered by the last person to receive shares became the price everyone paid, that is, the “clearing price”. However, Google stock

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[95] Article 4(1)(g) of Regulation 593/2008 (Rome I).

[96] See also Articles 24–26 of Regulation 593/2008 (Rome I).

[97] See Oh PB, The Dutch Auction Myth, Wake Forest L R 42 (2007) pp 853–910 at p 855.

jumped 18% on its debut. This indicates that the Dutch auction failed to create a high enough price for Google's shares.[98]

Dual-track IPO/trade sale process. Trade sellers and private equity sponsors sometimes combine an auction process with an IPO process. A dual track IPO/trade sale process means that the vendor pursues a trade sale through a competitive auction process with trade or financial buyers but switches to the IPO track with pricing determined by institutions on a bookbuilding basis.

The use of a dual track IPO/trade sale process can bring some benefits. Generally, the dual track process can increase the chances that the exit will take place. In addition, prospective bidders have an incentive not only to bid higher than each other but also to provide an alternative to an IPO. Prospective bidders therefore have an incentive to close their bids according to the IPO schedule and on clean exit terms.

On the other hand, there are some drawbacks. Pursuing two parallel processes means higher transaction costs for the vendor. The IPO process will be compromised unless the vendor can ensure confidentiality of information disclosed in the sale process. The IPO track can extend the timeline to completion. It can be difficult to put an offer from a trade or financial buyer on hold after the vendor has switched from the trade track to the IPO track. It can be difficult to revert back to the trade sale exit route after pursuing the IPO track. In addition, investment banks that advise the vendor are biased towards the IPO.

Bought IPO. A "bought IPO" can help to cure some of those drawbacks. A "bought IPO" is an alternative to a dual track IPO process. In a London "bought IPO", the vendor invites an AIM broker to participate in a competitive auction process. The broker tries to acquire the business or shares for a company that will immediately apply for a listing on the AIM. This means that the broker is competing like any other prospective purchaser to acquire the business or shares. A "bought IPO" is usually fully underwritten by the broker. In order to reduce its own risk exposure, the broker usually seeks back-to-back commitments from institutional investors.

An example of such a bought IPO process was the sale by IBS AB, a Swedish company, of all shares in IBS (Public Services) Ltd, one of its UK subsidiaries. The bought IPO process included an accelerated IPO process and a trade sale process involving an auction process with trade and financial buyers. In March 2005, IPO (Public Services) Limited was ultimately acquired by IBS OPENSystems plc, a newly-incorporated, AIM listed company formed specifically to acquire IBS (Public Services) Ltd. The transaction was conditional upon admission to listing and trading of IBS OPENSystems plc on the London Stock Exchange.

Mandatory auction in deadlock situation. In exceptional cases, the auction sale is mandatory for the orderly resolution of a deadlock situation. The City Code on Takeovers and Mergers provides an example.

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[98] See *ibid*, p 856.

Where there are two competing takeover bids for shares listed on the London Stock Exchange and either offer may be increased or otherwise revised because neither offeror has declared its offer final, the Takeover Panel may establish an auction procedure.[99]

The procedure was used in 2006 when Tata Steel UK Limited and CSN Acquisitions Limited submitted competing offers for Corus Group plc. There was a deadlock situation, because neither offeror had declared its offer final. In order to provide an orderly framework for the resolution of this competitive situation, the Panel Executive established an auction procedure in accordance with Rule 32.5 of the Takeover Code. Each of the parties agreed to the terms of the auction procedure. Tata eventually prevailed in an all-night auction.

This is how Corus described the agreed form of auction on 26 January 2007: "The auction procedure will consist of a maximum of nine rounds, comprising up to eight rounds in which each offeror is able to lodge a fixed price bid in cash followed by, if the auction procedure has not by then concluded, a final round. In the final round each offeror is able to lodge either a fixed price bid in cash or a cash bid calculated by reference to a formula pursuant to which an offeror can lodge a bid at a specified amount in cash more than the other offeror subject to a specified maximum cash amount. In respect of the first eight rounds of the auction procedure, a subsequent round will only take place if the offeror which has the lower cash bid as at the beginning of that round (or, if at that time the highest cash bids of both offerors are at the same price, either offeror) lodges an increased cash bid in that round. Such a cash bid must be not less than 5p higher than the higher cash bid as at the beginning of that round (or, if at that time the highest cash bids of both offerors are at the same price in cash, not less than 5p above the price of those bids). However, if an offeror which has the higher cash bid as at the beginning of a round lodges an increased bid in that round, it is not subject to any minimum increment."

Excursion: Issuing of bonds through auction. In corporate finance, another usual situation that involves the use of an auction is the issuing of bonds. This is how the ECB described a typical primary market auction for euro-denominated bonds:[100]

"In a typical primary market auction, investors can submit (sealed) bids specifying quantities and prices that the bidding investor is prepared to pay. The quantity that the investor receives and the price the investor has to pay is then determined on the basis of all bids according to pre-defined rules. Government bond auctions are organised as uniform price auctions, i.e. all bidders pay the same (issue) price, including those who submitted bids with a higher price. Or they are organised as multiple price auctions, as in France and Germany, where bidders always pay the price that they have submitted.

Direct participation in an auction may be restricted to a group of financial firms, called primary dealers. Virtually all auctions are carried out fully electronically. Large government bond issuers typically operate electronic auction systems themselves. Smaller issuers use electronic auction systems operated by, for example, an entity that also offers electronic secondary market trading facilities (such as a regulated securities exchange or an alternative trading system). During the internet boom, some primary market bond auctions were car-

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[99] Rule 32.5 of the Takeover Code.

[100] ECB, The euro bonds and derivatives markets (June 2007) p 33.

ried out via the internet so that retail investors could also participate directly. However, internet auctions no longer appear to be used for the issuance of debt securities."

IPO

The legal aspects of initial public offerings of securities were already discussed in section 5.10 above. While private sales of shares are mostly unregulated at Community level, Community law plays a more important role in the capital markets.

Public offering, prospectus. A sale through a public offering can require the publication of a prospectus under the Prospectus Directive.[101] The prospectus must not be published until it has been approved by the competent authority of the home Member State according to the home-country principle.[102]

Application for a listing, prospectus. A shareholder cannot carry out an IPO without the co-operation of the firm. Where shares have not yet been admitted to trading on a regulated market in the EU, the party that is entitled to apply for admission is the issuer, that is, the company whose securities are the subject of the application for listing.[103]

The application for admission to official listing must cover all the shares of the same class already issued.[104] However, where the securities have been admitted to trading on a regulated market, they can subsequently be admitted to trading on other regulated markets even without the consent of the issuer.[105]

Any admission of securities to trading on a regulated market in the area of the EU is subject to the publication of a prospectus.[106]

Share Exchange Offers by a Third Party

Share exchange offers enable a shareholder to convert holdings in one company into holdings in another company. Questions of company law and capital markets law raised by share exchange offers have already been discussed in sections 5.11.5 and 5.11.6. Some general remarks can nevertheless be made.

Company law aspects of share exchanges. A share exchange offer raises questions of company law in the company making the offer.

Under the European legal capital regime, shareholders in general meeting either decide on the issuing of new shares or authorise the board to decide on the matter. As shareholders usually have pre-emptive rights to new shares issued by the company, a decision to issue new shares will have to be complemented by a decision to waive pre-emptive rights in share exchange offers. The valuation of shares issued by the company and the valuation of shares of the target company can be important, because a low valuation of shares issued by the company and a high

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[101] Articles 3(1) and 3(3) of Directive 2003/71/EC (Prospectus Directive).
[102] Articles 3(1) and 13(1) of Directive 2003/71/EC (Prospectus Directive).
[103] Articles 1(a), 5 and 11 of Directive 2001/34/EC (Listing Directive).
[104] Article 49(1) of Directive 2001/34/EC (Listing Directive).
[105] Article 40(5) of Directive 2004/39/EC (MiFID).
[106] Article 3(3) of Directive 2003/71/EC (Prospectus Directive).

valuation of shares in the target company can prejudice the interests of the issuing company's existing shareholders and infringe provisions of company law that protect shareholders in general.

In the target company, a share exchange offer can raise questions relating to the use of takeover defences as well as questions on whether the offeror can be permitted to inspect the target company (due diligence). Furthermore, the exceeding of a certain threshold can trigger takeover defences under the target's articles of association. The articles of association may provide for other shareholders' sell-out rights or the acquirer's duty to make an offer for the remaining shares (section 18.4).

Securities markets law aspects of share exchanges. If one of the participating companies is a company whose shares have been admitted to trading on a regulated market, parties to the share exchange must comply with provisions of EU securities markets law.

There can be a duty to draw up and publish a prospectus under the Prospectus Directive (where the offeror's shares have been admitted to trading on a regulated market or the offeror will apply for their admission to trading) or an offer document under the Directive on takeover bids (where the target's shares have been admitted to trading on a regulated market).

According to the Directive on takeover bids, the board of the offeree company must draw up and make public a document setting out its opinion, and there are restrictions on the use of takeover defences that can frustrate the bid.

If the target company's shares have been admitted to trading on a regulated market, a successful share exchange can trigger a duty to make a mandatory bid for the remaining shares, a squeeze-out right and sell-out rights. It can also lead to the delisting of the target's shares.

Formation of a holding SE. Formation of a holding SE is one of the four ways of establishing an SE under the SE Regulation.[107] It is also a particular form of share exchange (see section 10.4.3 below).

Public Takeover Bids by a Third Party

Where a public offer is made for shares that have been admitted to trading on a regulated market, a detailed takeover regime will apply. The regime consists in particular of: the regulation of inside information (section 5.9.7); disclosure obligations (Chapter 19); the duty of equivalent treatment of holders of securities who are in a same position; and restrictions on the use of takeover defences (Chapter 18). In the EU, the most important rules governing these questions are based on: the Market Abuse Directive; the Directive on Takeover Bids; the Prospectus Directive; and the Transparency Directive.

Major holdings. The Transparency Directive lays down an obligation to disclose information about major holdings. A person acquiring or disposing of shares so that its holding with a publicly traded company reaches, exceeds or falls below certain thresholds must inform the company, which is in its turn responsible for

[107] Articles 2(2) and 32 of Regulation 2157/2001 (SE Regulation).

disclosing this information to the public. The thresholds are 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75% of voting rights.

Information that influences share price. The Market Abuse Directive not only prohibits abuse but requires issuers to publish inside information, that is, "information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments".

Under some circumstances, disclosure of inside information may be delayed, provided that the delay would not be likely to mislead the public and the issuer is able to ensure the confidentiality of that information. An NDA and transaction-specific insider lists are therefore a must in takeovers where at least one of the participating companies has gone public.

Prospectus or offer document. The Prospectus Directive and national provisions that implement it require the issuer to publish a prospectus when securities are offered to the public. The prospectus must contain all information which, according to the particular nature of the issuer and of the securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities.

However, there are many exemptions from the obligation to publish a prospectus. Exemptions apply when securities are offered in connection with a takeover by means of an exchange offer, provided that a document is available containing information which is regarded by the competent authority as being equivalent to that of the prospectus. The Directive on takeover bids requires the publication of such an offer document.

Directive on takeover bids. The core rules governing public takeover bids have been approximated by the provisions of the Directive on takeover bids.

In October 2002, the European Commission presented a proposal for a Directive on takeover bids after an earlier proposal was narrowly rejected by the European Parliament in July 2001. Countries like Germany and Sweden had voted against the earlier proposal because they believed that the proposal would have limited the use of takeover defences and increased cross-border takeovers and foreign ownership of companies. The UK had voted in favour of the earlier proposal because UK-based financial firms would have been likely bidders and the proposal was, to a large extent, based on the provisions of the City Code on Takeovers and Mergers. The new proposal was accepted.

The Directive ensures a basic level of disclosure of information during a takeover bid and provides that shareholders, in particular minority shareholders, should be afforded a minimum level of protection equivalent throughout the EU.

Scope. The Directive on takeover bids applies to "takeover bids for the securities of companies governed by the laws of Member States, where all or some of those securities are admitted to trading on a regulated market … in one or more

Member States".[108] A takeover bid has been defined as "a public offer (other than by the offeree company itself) made to the holders of the securities of a company to acquire all or some of those securities, whether mandatory or voluntary, which follows or has as its objective the acquisition of control of the offeree company in accordance with national law".[109] "Securities" in this context is defined as transferable securities carrying voting rights in a company.[110]

General principles. Like the City Code on which it is largely based, the Takeover Directive provides for general principles (see sections 19.9 and 17.2).

One of them is the principle of equivalent treatment of holders of securities of an offeree company of the same class. The Directive does not provide for automatic equal treatment of all shareholders or holders of all securities. Another important principle is the duty of the board of an offeree company to act in the interests of the company as a whole.[111]

The principles are minimum requirements. Member States may lay down additional conditions and more stringent provisions for the regulation of bids.[112]

Supervisory authority and applicable law. Before the Directive on takeover bids, it was possible that the supervisory authorities of two or more Member States had overlapping powers to supervise the same takeover bid. The Directive ensures that only one supervisory authority supervises the bid in normal cases that involve a target company which is registered in a Member State and whose securities are admitted to trading on a regulated market in a Member State.[113]

The supervisory authority will be determined by the location of the regulated market on which the target's securities are admitted to trading. The Directive contains special rules on multiple listings. The Directive does not address the very unusual case that there are more than one offeree companies (for the Eurotunnel case, see section 5.11.6).

The Directive on takeover bids does not contain choice of law rules. For example, each administrative authority will apply the law that governs its own activities. For a company registered in a Member State and having its central administration in that or another Member State, company law aspects will be governed by the law of the country in which it is registered.

Information on the takeover bid. The Directive on takeover bids requires the disclosure of information that enables shareholders to reach a properly informed decision on the bid. The disclosure of information requires many steps.

First, the offeror must make its decision to make a bid public without delay and inform the supervisory authority of the bid.[114]

Second, the boards of the offeree company and of the offeror must inform their respective employees of the bid as soon as the bid has been made public.[115]

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[108] Article 1(1) of Directive 2004/25/EC (Directive on takeover bids).
[109] Article 2(1)(a) of Directive 2004/25/EC (Directive on takeover bids).
[110] Article 2(1)(e) of Directive 2004/25/EC (Directive on takeover bids).
[111] Article 3(1) of Directive 2004/25/EC (Directive on takeover bids).
[112] Article 3(2) of Directive 2004/25/EC (Directive on takeover bids).
[113] Article 4 of Directive 2004/25/EC (Directive on takeover bids).
[114] Article 6(1) of Directive 2004/25/EC (Directive on takeover bids).
[115] Article 6(1) of Directive 2004/25/EC (Directive on takeover bids).

Third, the offeror must draw up an offer document and communicate it to the competent supervisory authority.[116]

Fourth, where the offer document is subject to the prior approval of the competent supervisory authority, the offeror must obtain approval before making the offer document public.[117]

Fifth, if the offer document is subject to the prior approval of the supervisory authority and has been approved, the offeror may need to translate it and include additional information before communicating it to the supervisory authority of another Member State before making the offer document public in that Member State.[118]

Sixth, the offeror must make the offer document or documents public in the Member State or Member States in which securities issued by the offeree are admitted to trading on a regulated market.[119]

Seventh, the board of the offeree company must draw up and make public a document setting out its opinion of the bid and the reasons on which it is based. The board of the offeree company must communicate that opinion both to the company's shareholders and to its employees.[120]

However, the Directive on takeover bids does not require the use of external fairness opinions (see below).

Contents of the offer document. The Directive on takeover bids sets out the required minimum contents of the offer document.

The minimum general requirement is that the offer document contains the information necessary to enable the holders of the offeree company's securities to reach a properly informed decision on the bid.[121]

In addition to the general requirement, the Directive lists several things that must be included in the offer document. For example, they include: the terms of the bid; the consideration offered for each security; the offeror's intentions with regard to the future business of the offeree company; and all the conditions to which the bid is subject.[122]

The rule on supervisory authority is complemented by a rule on the recognition of offer documents that have been approved by the supervisory authority of a Member State. It would be very difficult to make a bid if the supervisory authorities of many Member States required the filing and disclosure of different offer documents. The Directive on takeover bids solves this problem in the following way:

"Where the offer document referred to in the first subparagraph is subject to the prior approval of the supervisory authority and has been approved, it shall be recognised, subject to any translation required, in any other Member State on the market of which the offeree

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[116] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).
[117] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).
[118] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).
[119] Articles 6(2) and 8 of Directive 2004/25/EC (Directive on takeover bids).
[120] Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).
[121] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).
[122] Article 6(3) of Directive 2004/25/EC (Directive on takeover bids).

company's securities are admitted to trading, without its being necessary to obtain the approval of the supervisory authorities of that Member State. Those authorities may require the inclusion of additional information in the offer document only if such information is specific to the market of a Member State or Member States on which the offeree company's securities are admitted to trading and relates to the formalities to be complied with to accept the bid and to receive the consideration due at the close of the bid as well as to the tax arrangements to which the consideration offered to the holders of the securities will be subject."[123]

Contents of the opinion of the board of the offeree company. The board of the offeree company will give an opinion of the bid and the reasons on which its opinion is based. In the opinion, the board must give its views on: the effects of implementation of the bid on the company's interests in general (and on employment in particular); the offeror's strategic plans for the offeree company; and the likely repercussions of the offeror's strategic plans on employment and the locations of the company's places of business.[124]

Fairness opinions. As said above, the Directive on takeover bids does not require the use of external fairness opinions. Fairness opinions are nevertheless usual in takeovers.

Some external opinions are required in a company that issues shares – typically, the offeror rather than the offeree – under other Company Law Directives and the provisions of Member States' national company laws implementing those Directives.[125] However, such statutory opinions are not regarded as "fairness opinions" in market practice.

In many countries, the use of external fairness opinions is based on market practice rather than law. It is a legal requirement in England. The City Code on Takeovers and Mergers requires the board of the offeree company to appoint an "independent adviser" and to make the independent adviser's advice known to shareholders.[126]

Board members and managers have an incentive to use external fairness opinions. External fairness opinions can signal that they have not acted negligently. In addition, external fairness opinions can be used for marketing reasons to signal the benefits of the offer.

Restrictions on the use of takeover defences. The Directive on takeover bids restricts the use of takeover defences during the bid (without prohibiting them, see sections 17.2 and 17.4).

Before the bid, the board can take defensive measures within the limits of national company law. The company must nevertheless disclose structural takeover defences in its annual report.[127]

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[123] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).
[124] Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).
[125] See, in particular, Article 27 of Directive 77/91/EEC (Second Company Law Directive) and Article 10 of Directive 78/855/EEC (Third Company Law Directive).
[126] Rule 3.1 of the City Code on Takeovers and Mergers.
[127] Article 10 of Directive 2004/25/EC (Directive on takeover bids).

During the bid, the board of the offeree company is prohibited from taking any action which may result in the frustration of the bid, unless the board has obtained the prior authorisation of shareholders in general meeting for this purpose. In particular, the board may not issue any shares which may result in a lasting impediment to the offeror's acquiring control of the offeree company.[128] The notice period for calling the general meeting of shareholders for those purposes must be longer than two weeks.[129]

Many capital transactions such as the issue of new shares, derogation from shareholders' pre-emptive rights, and share buybacks would require the consent of shareholders also under the Second Company Law Directive.

During the bid, the board of the offeree company may not implement its own previous decisions, if they do not form part of the normal course of the company's business and if their implementation may result in the frustration of the bid. The board may implement such a decision with the consent of shareholders.[130]

However, there are many things that the offeree company's board can do. The company is not prevented from carrying on business as usual. In its opinion, the board can recommend to shareholders either the rejection or the acceptance of the bid. The board is not prohibited from taking measures which are not likely to frustrate the bid. Neither is the board prohibited from seeking alternative bids (the "white knight" defence). Furthermore, the board is not restricted from implementing previous decisions taken by the general meeting. If a decision is authorised by the general meeting in advance, it does not matter that it may result in the frustration of the bid.[131]

The break-through rule. In principle, the break-through rule and the squeeze-out right could make it easier for a bidder that has obtained a large block of shares to obtain control of the company.

In practice, however, there is no "level playing field" in Europe as far as the break-through rule is concerned, because the Directive on takeover bids makes the break-through rule optional for Member States.[132]

If adopted by the Member State, the break-through rule will "break through" many structural takeover defences. This means that multiple-vote securities carry only one vote each at the general meeting of shareholders which decides on any defensive measures in accordance with the Directive.[133] If the offeror holds 75% or more of the capital carrying voting rights, multiple voting rights and voting restrictions do not prevent the offeror from changing the board and amending the articles of association at the first general meeting following the bid. On the other hand, a shareholder that controls more than 25% of the company can block the change of those structural takeover defences.

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[128] Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).
[129] Article 9(4) of Directive 2004/25/EC (Directive on takeover bids).
[130] Article 9(3) of Directive 2004/25/EC (Directive on takeover bids).
[131] Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).
[132] Article 12 of Directive 2004/25/EC (Directive on takeover bids).
[133] Article 11 of Directive 2004/25/EC (Directive on takeover bids).

Golden shares. The Directive on takeover bids is silent on "golden shares". Golden shares typically mean special control rights that a Member State has in a state-owned or partly state-owned company. It was not necessary to adopt any particular rules on golden shares, because golden-share type arrangements are usually prohibited by the EC Treaty or acceptable only in rare circumstances.[134]

For example, the German VW-Gesetz (VW Law)[135] provided that no shareholder could vote with more than 20% of the share capital at the general meeting of Volkswagen AG and that important decisions, which in other companies only require 75% of the votes required more than 80% of the votes in that company. With its interest of approximately 20% of shares, the Land of Lower Saxony (Niedersachsen) could block important decisions. Furthermore, the Federal State and the Land of Lower Saxony were each allowed to appoint two representatives to the company's supervisory board under the VW Law. In 2007, the ECJ held that parts of the VW Law were not compatible with Article 56(1) of the EC Treaty.[136] This case – and further litigation caused by the initial reluctance of the German government to fully comply with its obligations under the EC Treaty – paved the way for the attempted takeover of Volkswagen AG by Porsche Automobil Holding SE.

Squeeze-out right and sell-out right. If the bidder has obtained 90%-95% of the company following the bid (some variations are possible depending on the Member State), the squeeze-out right enables him to require all the holders of the remaining securities to sell him those securities at a fair price (section 5.11.7).[137] The result is that the bidder will own 100% of the offeree company. The bidder's actions will then not be constrained by minority shareholders' rights.

The Directive on takeover bids provides for minority shareholders' sell-out rights. The provisions on sell-out rights mirror those on squeeze-out rights.[138]

Mandatory bids. The Directive on takeover bids also contains rules on mandatory bids (see below). However, the mandatory bid rule does not apply "where control has been acquired following a voluntary bid made in accordance with this Directive to all the holders of securities for all their holdings".[139]

Mandatory Takeover Bids by a Third Party

In companies whose shares have been admitted to trading on a regulated market, minority shareholders are protected in three ways under the Directive on takeover bids.

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[134] The earliest cases were Case C-367/98 Commission v Portugal [2002] ECR I-4731, paragraph 38; Case C-483/99 Commission v France [2002] ECR I-4781, paragraph 37; and Case C-503/99 Commission v Belgium [2002] ECR I-4809, paragraph 38.

[135] Gesetz über die Überführung der Anteilsrechte an der Volkswagenwerk Gesellschaft mit beschränkter Haftung in private Hand.

[136] Case C-112/05 Commission v Germany [2007] ECR I-8995.

[137] Article 15 of Directive 2004/25/EC (Directive on takeover bids). For German law, see § 327a AktG.

[138] Article 16 of Directive 2004/25/EC (Directive on takeover bids).

[139] Article 5(2) of Directive 2004/25/EC (Directive on takeover bids).

First, the Directive lays down general rules on the disclosure of information, on equivalent treatment, and on board duties during a public takeover bid.

Second, minority shareholders have a sell-out right following a public takeover bid provided that the ownership of the bidder has exceeded the threshold of 90%-95%.

Third, the Directive provides for a duty to make a mandatory bid where the holdings of a shareholder exceed a certain threshold other than following a public takeover bid. The requirements under the Directive on takeover bids are minimum requirements and Member States may lay down more stringent rules and additional conditions.[140]

Duty to make a bid. The duty to make a mandatory bid is triggered when a certain threshold is exceeded, but the Directive is silent on the threshold. The threshold is a percentage of voting rights which confers control. The threshold and the method of its calculation are determined by the rules of the Member State in which the company has its registered office.[141]

In any case, the percentage of the voting rights of the offeror will be combined with the voting rights of "persons acting in concert" (section 19.9).[142] "Persons acting in concert" mean "natural or legal persons who cooperate with the offeror … on the basis of an agreement, either express or tacit, either oral or written, aimed … at acquiring control of the offeree company …"[143] The minimum equitable price payable by the offeror is increased by the price paid by persons acting in concert.[144]

Notes on Rule 9.1 of the City Code on Takeovers and Mergers contain detailed guidance on the meaning of acting in concert. In Germany, such rules can be found in § 30(2) WpÜG.[145]

There is no retroactivity for old shareholdings. Recital 10 of the Directive states: "The obligation to make a bid to all the holders of securities should not apply to those controlling holdings already in existence on the date on which the national legislation transposing this Directive enters into force."

For example, Volkswagen acquired shares corresponding to 34% of the voting rights in Scania in 2000. When the mandatory bid threshold was introduced in the Swedish Takeover Act on 1 July 2006, VW could represent 34% of the votes at the general meeting of Scania. The Takeover Act exempted any shareholder holding 30% or more of the votes on 1 July 2006 from the mandatory bid rule. In 2008, Volkswagen increased its holdings to 68.6% of

[140] Article 3(2) and recital 25 of Directive 2004/25/EC (Directive on takeover bids).
[141] Articles 5(1) and 5(3) of Directive 2004/25/EC (Directive on takeover bids).
[142] Article 5(1) of Directive 2004/25/EC (Directive on takeover bids).
[143] Article 2(1)(d) of Directive 2004/25/EC (Directive on takeover bids).
[144] Article 5(4) of Directive 2004/25/EC (Directive on takeover bids).
[145] For Swiss law, see Art. 27 BEHV-EBK (Börsenverordnung-EBK, Verordnung der Eidgenössischen Bankenkommission über die Börsen und den Effektenhandel). For Austrian law, see § 1 number 6 ÜbG (Übernahmegesetz). See also Fleischer H, Finanzinvestoren im ordnungspolitischen Gesamtgefüge von Aktien-, Bankaufsichts- und Kapitalmarktrecht, ZGR 2008 pp 198–199.

votes. As Volkswagen benefited from its so-called "grandfather status", there was no obligation make a mandatory bid.[146]

If there is a duty to make a bid, the bid must be addressed at the earliest opportunity to all the holders of those securities for all their holdings at the equitable price as defined in the Directive.[147] The mandatory bid rule does not apply where control has been acquired following a voluntary bid.[148]

Consideration and price. The bidder must pay "the equitable price". The equitable price is the highest price paid by the bidder over a certain period. The Member States may choose the length of the period. The period must nevertheless be "not less than six months and not more than 12 before the bid".[149]

The consideration may consist of securities, cash, or a combination of both securities and cash. Where the consideration offered by the offeror does not consist of liquid securities admitted to trading on a regulated market, it must include a cash alternative.[150]

It can be more difficult to interpret mandatory bid rules following share exchanges. The Directive on takeover bids does not require any mandatory bid where "control has been acquired following a voluntary bid made in accordance with [the Directive] to all the holders of securities for all their holdings".[151] However, where the voluntary bid did not fulfil those conditions, the outcome of the voluntary bid can trigger an obligation to make a mandatory bid for all remaining transferable securities carrying voting rights in the target company at "the equitable price";[152] alternatively, the share exchange may not have been part of a bid. The equitable price depends on "the highest price" paid by the bidder during a certain period of time.[153] But if the consideration consisted of the bidder's own shares, the value of both those shares and the target's shares may fluctuate. Where the price of the bidder's shares has increased, the value of shares held by shareholders who accepted the prior is higher than the original cash value of "the highest price". Where the price of the target's securities has increased more, the original conversion ratio has become unfavourable to remaining shareholders. Basically, the supervisory authorities are not entitled to adjust the "equitable price" after normal market movements.[154]

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[146] See also Stattin D, Dispenser från budplikt vid Volkswagens köp av Scania-aktier, JT 2007–08 pp 873–881.

[147] Article 5(1) of Directive 2004/25/EC (Directive on takeover bids).

[148] Article 5(2) of Directive 2004/25/EC (Directive on takeover bids).

[149] Article 5(4) of Directive 2004/25/EC (Directive on takeover bids).

[150] Article 5(5) of Directive 2004/25/EC (Directive on takeover bids).

[151] Article 5(2) of Directive 2004/25/EC (Directive on takeover bids).

[152] Article 5(1) of Directive 2004/25/EC (Directive on takeover bids).

[153] Article 5(4) of Directive 2004/25/EC (Directive on takeover bids).

[154] Article 5(4) of Directive 2004/25/EC (Directive on takeover bids).

10.3.3 Termination of a Joint-Venture

A commercial joint-venture typically involves the coordinated use of strategic assets from two or more parties to achieve a result that benefits all parties. A commercial joint-venture is not a mere financial investment. Typically, the business venture has a value even separated from its owners. The change of one owner will not have to mean the end of the business venture. Such business ventures range from unincorporated joint-ventures to incorporated limited-liability companies. Regardless of the form of the joint-venture, the parties have typically regulated their mutual relations in a joint-venture agreement.

Exit plans. The exit plans of the parties depend on the purpose of the joint-venture. For example, a product-specific joint-venture will expire commercially at the end of the product life, a joint-venture for the development of a market for a product can end through the joint sale of the joint-venture or an IPO, and a joint-venture for the integration of complementary products or services can result in a merger. The joint-venture can thus expire as a business venture on termination, survive the termination, or be merged into one of the parties.

In a two-party joint-venture, a party could, in principle, realise the full value of the joint-venture either through obtaining control or through the sale of its interests in the joint-venture. A party may buy or sell shares, or be forced to buy or forced to sell the shares. A party could, in principle, sell its interests either to the other party or to a third party. A party may have agreed on a duty to offer its interests to the other party. When selling its interests to a third party, that party may act jointly with the other party or unilaterally. A party may thus buy or sell the shares, or be forced to buy or forced to sell the shares.

Contractual regulation of exit and termination. The termination of a joint-venture can be triggered by many things.

Some of the events that can trigger termination are common to all long-term contracts. Default by the other party can give the aggrieved party a right to terminate the contract. A party can have a right to terminate the contract in the event of change of control of the other party. Material adverse change may be listed as a general termination event, and a general material adverse change clause may be complemented by clauses on failure to achieve the purpose of the joint-venture or its failing financial condition.

There are also particular termination clauses used in joint-ventures. The parties will need to address the risk of deadlock situations and regulate the situation where one party wants to exit the joint-venture before the expiry of the agreed term of the contract.

As a commercial joint-venture is not a mere financial investment, exit terms belong to core terms of the joint-venture agreement, and there are particular ways to agree on questions of exit and removal in this context. Three special situations arise in a joint-venture controlled by two parties: exit by both parties; exit by one party; and removal of the other party.

Exit by both parties. Both parties may want an exit. In this case, unilateral action by one party might exclude some forms of exit and prevent the other party from obtaining a high price. The joint-venture contract can therefore contain re-

strictions on the unilateral disposal of shares and other unilateral action and provide for a joint exit process.

Exit by one party. The success of two-party business ventures depends on the contribution of both parties, but one of the parties may want an exit whereas the other may not yet want this.

The parties will normally regulate this question in advance. The joint-venture agreement can contain a termination clause. In addition, the parties will need to decide what will happen on termination. The business venture can either continue as a going concern or be liquidated. The parties will have continuing obligations that will survive the expiry of the contract or no such obligations. A party can have a right to sell its interests to a third party or to the other party (a sell-out right). Typically, the other party will prefer to be protected by a long notice period.

The term and termination of the joint-venture agreement must be distinguished from the existence of the joint-venture as a separate business entity and the termination of that business entity. For example, where the joint-venture has been incorporated as a limited-liability company, the termination of the joint-venture agreement between its shareholders does not mean the liquidation of the company. The liquidation of the company typically requires an internal decision by the company. Where a business entity is based on a contract between its shareholders, the termination of that contract can nevertheless mean the liquidation of the business entity. For example, the contract founding a GmbH under German law can provide that a shareholder can terminate the contract by notice and cause the GmbH to be liquidated.[155]

Removal of the other party. In some business ventures, each party wants to remove the other party and keep the whole business venture and change the nature of its investment. The contractual regulation of the removal of the other party is legally complicated, because neither party wants to be removed.

First, there must be a contractual mechanism that protects the aggrieved party in the event of breach of contract by the other party. For example, the agreement may provide that the aggrieved party may acquire the other party's shares in the joint-venture company at a fair market value following material breach of contract by the other party.

Second, there must be an exit mechanism that does not require breach of contract by the other party. The parties often choose a "Russian roulette clause" or a "Texas shoot-out clause".

A "Russian roulette" clause means that either party can serve notice on the other offering either to buy the other's shares or to sell its own shares to the other party at a specified price. The offer must be accepted. Failure to accept the offer means that the party is obliged to sell all its own joint venture shares to the offeror at that price.

Alternatively, the parties may agree on a "Texas shoot-out". A Texas shoot-out is most common in a 50:50 joint venture. A Texas shoot-out means that both par-

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[155] § 60(2) GmbHG: "Im Gesellschaftsvertrag können weitere Auflösungsgründe festgesetzt werden."

ties will submit a secret and sealed bid to a third party. The party with the lower bid must sell its shares to the higher bidder at the higher price.

In the English case of *Banner Homes Group plc v Luff Developments Ltd*,[156] a Texas shoot-out was understood to mean "an arrangement under which either party could offer put and call options at a specified price or prices which the other could accept or refuse".

Third, a party may in practice be able to use a combination of removal mechanisms. The case of Baltic Beverages Holdings (BBH) provides an example of the simultaneous use of many removal mechanisms.

Case: BBH. In 2007, BBH was a company jointly owned by Carlsberg A/S, a large Danish brewer, and Scottish & Newcastle plc, a large brewer based in Edinburgh. BBH was a market leader in the growing Russian beer market and the jewel in the crown of both companies.

The BBH Shareholders' Agreement between Carlsberg and Scottish & Newcastle ran to 2050. It set out express obligations such as a duty of loyalty and provided that, following material breach of contract by one party, the aggrieved party had a right to acquire the other party's shares in BBH at a fair market value. In addition, the Agreement contained a "Texas shoot-out" clause or a "shotgun clause": if one party made an offer, the other had six months to better it or take the money.

Carlsberg decided to seize control of Scottish & Newcastle's share of BBH. Scottish & Newcastle being a listed company, Carlsberg joined forced with Heineken N.V., a large Dutch brewer. Their plan was to split Scottish & Newcastle, with each party obtaining parts of its business.[157]

Scottish & Newcastle rejected their offer (section 10.4.2). Scottish & Newcastle also took defensive action under the BBH Shareholders' Agreement.

Scottish & Newcastle gave notice to Carlsberg of breaches by Carlsberg of the terms of the BBH Shareholders' Agreement. Scottish & Newcastle argued that the actions of Carlsberg constituted initiation of the voluntary termination provisions of the Shareholders' Agreement under which Carlsberg was obliged to offer its shares in BBH to Scottish & Newcastle. For this purpose, it also initiated formal arbitration proceedings in accordance with the Rules of the Arbitration Institute of the Stockholm Chamber of Commerce as provided for under the terms of the Agreement. The Arbitral Tribunal was requested to confirm that Carlsberg was obliged to offer its shares to Scottish & Newcastle in accordance with the Agreement. The key elements of the claim submitted by Scottish & Newcastle were: misuse of confidential information; breach of duty of loyalty and other express provisions in the Agreement; and circumvention of the early termination provisions of the Agreement.

In January 2008, Carlsberg and Heineken prevailed. The boards of Sunrise Acquisitions Limited ("BidCo"), a newly incorporated company jointly owned by Carlsberg and Heineken, and Scottish & Newcastle announced that they had

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[156] Banner Homes Group plc v Luff Developments Ltd and another [2000] EWCA Civ 18, [2000] 2 All ER 117.

[157] A similar scheme had proven successful some weeks earlier when a consortium of banks seized control of ABN AMRO, a large Dutch bank, after a takeover bid.

reached agreement on the terms of a recommended higher cash offer to be made by BidCo for the entire issued and to be issued share capital of Scottish & Newcastle. The offer was implemented by way of a court-sanctioned scheme of arrangement under section 425 of the Companies Act 2006. Under the scheme, each Scottish & Newcastle share was cancelled and new Scottish & Newcastle shares were issued fully paid to BidCo. In consideration for the cancellation of their shares, Scottish & Newcastle shareholders received cash.

10.3.4 Privatisation

Community Law

Privatisations are a particular form of exit. Privatisations are, to some extent, influenced by Community law. First, a functioning market economy and the capacity to cope with competitive pressure and market forces within the EU belong to the membership conditions of the EU (the "Copenhagen criteria"). One of the ways for applicants to ensure compliance with the membership conditions has been to privatise state-owned companies. Second, Community law can give incentives to privatise national commercial monopolies. Third, EU competition law can encourage Member States to separate the control of infrastructure from the provision of services. Fourth, the Commission has encouraged privatisations at a political level as a means to establish a more competitive internal market. Fifth, privatisations are subject to state-aid controls, the prohibition of discrimation on the basis of nationality, the freedom of establishment and capital movements, and the prohibition of golden shares.

No obligation to privatise. However, the main rule is that Community law does not require privatisations as such. Privatisations are within the sole discretion of Member States. It has explicitly been stated in the EC Treaty that the Treaty "shall in no way prejudice the rules in Member States governing the system of property ownership".[158]

Copenhagen criteria. The Treaty on European Union sets out the core membership conditions (Article 49 of the Maastricht Treaty).[159] They include respecting the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law.[160] Article 49 of the 1992 Maastricht Treaty was clarified at a meeting of the European Council in Copenhagen in June 1993. By the time they join, new members must have a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union, among other things. Whereas old Member States already had a market economy in place, former socialist countries applying for membership have privatised much of their economy by the time they have joined.

Privatisation of national commercial monopolies. Article 31(1) of the EC Treaty provides that "Member States shall adjust any State monopolies of a com-

[158] Article 295 of the EC Treaty.
[159] Article 49 of the Treaty on European Union.
[160] Article 6(1) of the Treaty on European Union.

mercial character so as to ensure that no discrimination regarding the conditions under which goods are procured and marketed exists between nationals of Member States".

Article 31(1) complements the prohibition of quantitative restrictions on imports and all measures having equivalent effect.[161] Prohibitions or restrictions on imports, exports or goods in transit are compatible with Community law only provided that they can be justified by public interest and they do not constitute any means of arbitrary discrimination or a disguised restriction on trade between Member States.[162]

The purpose of Article 31(1) of the EC treaty is to reconcile the possibility for Member States to maintain certain monopolies of a commercial character as instruments for the pursuit of public interest aims with the requirements of the establishment and functioning of the common market. It aims at the elimination of obstacles to the free movement of goods, save, however, for restrictions on trade which are inherent in the existence of the monopolies in question.[163]

For example, it was held in *Franzén* that a domestic monopoly on the retail of alcoholic beverages pursues a public interest aim where it aims to protect public health against the harm caused by alcohol;[164] such a monopoly is therefore not prohibited by the EC Treaty as such.

Article 31(1) thus does not require total abolition of State monopolies of a commercial character, but it can require them to be adjusted.[165] As far as sales monopolies are concerned, the ECJ has held that monopolies are not allowed if they are arranged in such a way as to put at a disadvantage, in law or in fact, trade in goods from other Member States as compared with trade in domestic goods.[166]

That was the case in *Hanner*.[167] The ECJ held in *Hanner* that the Swedish retail monopoly for pharmaceuticals operated by Apoteket AB was not consistent with Community law, because Apoteket was entirely free to select a product range of its choice and there were no structural safeguards or other measures that would have ensured that all discrimination was ruled out.[168]

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[161] Article 28 of the EC Treaty.
[162] Article 30 of the EC Treaty.
[163] Case C-189/95 Franzén [1997] ECR I-5909, paragraph 39.
[164] Case C-189/95 Franzén [1997] ECR I-5909, paragraph 41.
[165] Case C-438/02 Krister Hanner [2005] ECR I-4551, paragraph 34, citing Case 59/75 Manghera and Others [1976] ECR 91, paragraphs 4 and 5; Case 91/78 Hansen [1979] ECR 935, paragraph 8; Case 78/82 Commission v Italy [1983] ECR 1955, paragraph 11; Case C-387/93 Banchero [1995] ECR I-4663, paragraph 27; and Case C-189/95 Franzén [1997] ECR I-5909, paragraph 38.
[166] Case C-438/02 Krister Hanner [2005] ECR I-4551, paragraph 36; Case C-189/95 Franzén [1997] ECR I-5909, paragraph 40.
[167] Case C-438/02 Krister Hanner [2005] ECR I-4551.
[168] Case C-438/02 Krister Hanner [2005] ECR I-4551, paragraphs 42–44.

In *Rosengren and others*,[169] the ECJ held that the Swedish retail monopoly operated by Systembolaget was not consistent with Community law to the extent that private individuals were prohibited from importing alcoholic beverages, because such a restriction could not be regarded as being justified under Article 30 of the EC Treaty on grounds of protection of the health and life of humans.

As Systembolaget has a special social and public policy task, it is not for sale. However, the Swedish government sold Vin & Sprit, owner of the Absolut vodka brand, to Pernod for €5.6 billion after an auction process in 2008. The Swedish government also decided to sell the pharmacy monopoly Apoteket.

Dual roles and competition law. State monopolies or former state monopolies often have dual roles. First, an existing state monopoly might both act as a supervisory authority and provide services itself. Second, state monopolies or former state monopolies might both provide services and control infrastructure. The dual roles of state monopolies or former state monopolies can put existing competitors and new entrants in the services market at a disadvantage.

Generally, Article 82 of the EC Treaty prohibits the abuse of a dominant position. Furthermore, Article 86 of the EC Treaty provides that (1) EU competition law applies even to public undertakings and undertakings to which Member States grant special or exclusive rights and that (2) undertakings entrusted with "the operation of services of general economic interest or having the character of a revenue-producing monopoly" are subject to the rules on competition "in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them".[170]

In *France v Commission*[171] and *RTT v GB-Inno-BM*,[172] the ECJ held that a Member State may not entrust a public body with regulatory powers if that body simultaneously operates in the field it seeks to regulate and competes in that field with other undertakings.[173]

As a result, a structural separation of supervision from operations as well as operations from infrastructure can be necessary. This can lead to the privatisation of operations, infrastructure, or both.

Public procurement, the Maastricht criteria. Other factors which may give an incentive to privatise public undertakings include the regulation of public procurement (for dealing with government entities, see Volume II) and the Maastricht criteria for government deficits.

State-aid. Article 87(1) prohibits "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain

[169] Case C-170/04 Rosengren and others [2007] ECR I-4071.
[170] See Hou L, Uncovering the Veil of Article 86(2) EC. Available at SSRN.
[171] Case C-202/88 France v Commission [1991] ECR I-1223, paragraph 51.
[172] Case C-18/88 Régie des télégraphes et des téléphones v GB-Inno-BM SA [1991] ECR I-5941, paragraph 25.
[173] See Verhoeven A, Privatisation and EC Law: Is the European Commission "Neutral" with Respect to Public versus Private Ownership of Companies? ICLQ 45 (1996) p 865.

goods … in so far as it affects trade between Member States". Any plans to grant or alter aid must be notified to the Commission in advance under Article 87(3).

Privatisations can trigger the application of state-aid provisions in different ways. State aid may be involved, for instance, where the undertaking to be privatised receives capital contributions or grants before its sell-off (direct aid), or if certain conditions are imposed on the buyer of the privatised company that negatively influence the sale price (indirect aid). An example of the latter would be when the buyer of the company is required to ensure certain services at abnormally low tariffs.[174]

To establish whether a privatisation operation involves direct aid, the Commission uses the so-called "private market economy investor" or "prudent investor operating in a market economy" test. The ECJ has endorsed this principle.[175] There is aid if the conduct of a public sector entity as investor is not comparable to that of a private sector investor.

For example, the United Kingdom agreed to provide new capital of £800 million to the Rover Group upon its sale to British Aerospace in order to discharge the Group's debts for that amount. The sale price amounted to only £150 million. The Commission reasoned that, under market conditions, a private shareholder would not provide funds that exceeded the sale price to enable the company to discharge debts.[176]

Discrimination, restrictions on capital movements, golden shares. In the past, several Member States have attempted to favour their nationals over individuals or companies of other Member States. Such discrimination is illegal, because the EC Treaty prohibits discrimination on the basis of nationality.[177]

The prohibition of discrimination is complemented by Treaty provisions on freedom of establishment[178] and provisions on the free movement of capital.[179]

Member States often try to maintain domestic control over undertakings they privatise. Many public enterprises are considered part of the core economy of a Member State because they provide essential utilities, are regarded as national champions, or are symbolic of the State. To this end, Member States can be tempted to accompany their privatisation programmes with various restrictions, including "golden shares".[180] However, golden-share type arrangements are normally prohibited by the EC Treaty or are acceptable only in rare circumstances.

Case: "Sparkassen". Problems relating to the application of Treaty provisions to privatisations can be illustrated by the *Sparkassen* case. Sparkasse – savings

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[174] See Verhoeven A, *op cit*, p 866.

[175] Case 323/82 Intermills v Commission [1984] ECR 3809. For more recent cases, see Case C-197/99 P Belgium v Commission [2003] ECR I-8461; Case C-482/99 France v Commission [2002] ECR I-4397. See Verhoeven A, *op cit*, p 867.

[176] Verhoeven A, *op cit*, p 871.

[177] Article 12 of the EC Treaty. See also Article 48 of the EC Treaty on companies and firms treated in the same way as as natural persons who are nationals of Member States.

[178] Article 43 of the EC Treaty.

[179] Article 56 of the EC Treaty.

[180] Verhoeven A, *op cit*, pp 878 and 884–886.

bank – is a regional public sector bank. The Sparkasse brand is powerful in Germany.

In June 2006, the Commission sent a reasoned opinion to Germany, because the name Sparkasse could only be used by public sector banks under § 40 of the German Banking Act (Gesetz über das Kreditwesen, Kreditwesengesetz, KWG). According to the Commission, this prevented private sector investors from benefiting from the goodwill value of the name following a privatisation and thereby infringed EC Treaty provisions on the freedom of establishment (Article 43) and the free movement of capital (Article 56).

In December 2006, the Commission and the German authorities reached agreement on the basis of the principle of neutrality of Community law as regards the decision to privatise a public enterprise in general and Sparkassen in particular (Article 295 of the EC Treaty). It was agreed that the privatisation of Sparkassen is within the sole discretion of Member States.

Furthermore, the parties agreed that Member States can require the Sparkassen to continue to meet certain public service obligations after a privatisation. A number of public service obligations that are typical for Sparkassen were identified and regarded as compatible with Community law. These obligations include ensuring the area-wide provision of service to economically weaker sections of the population and to small and medium-sized businesses, as well as guaranteeing the regional principle in accordance with the relevant Sparkassen law.

Furthermore, the Commission and the German authorities agreed on the duty of Member States to respect Community law in the application of national law (Article 10 of the EC Treaty). According to their agreement, § 40 KWG will be applied in a manner that does not infringe the provisions of the EC Treaty on the right of establishment and the movement of payments and capital, and § 40 KWG is superseded by higher ranking and directly applicable Community law.

Methods of Privatisation

In the EU, the methods of privatisation are constrained by Community law. Usual privatisation methods include: trade sale to one buyer; sale to a small group of investors as a private placement; public offering; and sale to employees. Each method of privatisation has its commercial advantages and disadvantages as well as legal advantages and disadvantages.

Trade sale. From a legal perspective, a trade sale is simple. A trade sale will result in the firm having a controlling shareholder. Weaker information asymmetries before the sale and the buyer's private benefits of control after the sale can increase the price that the buyer is prepared to pay. If an auction process is used, foreign investors cannot be prevented from bidding.

Private placement. From a legal perspective, a sale through a private placement resembles a trade sale. The biggest difference is that the firm will not typically end up having one controlling shareholder. This can mean that the firm will fail to obtain an optimal governance structure. Furthermore, as the private benefits of control will be shared by many investors, there might be a discount compared with a trade sale.

Public offering. A public offering is legally more complicated and expensive than a trade sale or a private placement. It requires the existence of relatively well-developed and liquid capital markets and legal infrastructure. On the other hand, a public offering can also foster the development of a capital market and equity culture. Stronger information asymmetries and the lack of private benefits of control for the investors mean that there is a discount on price and that the seller tends to take underpricing for granted.

Sale to employees. Sale to employees is probably the weakest alternative. On one hand, it may be easier to gain employee support for a sale to employees themselves. It could also be argued that the alignment of employees' interests with those of the firm's owners will give an incentive to improve efficiency. On the other, selling the firm to its employees would result in a weak corporate governance structure. Employees are typically more concerned about terms of employment and wages than the profitability of the firm.

Mix. The owner can also use a mix of privatisation methods. For example, the government of a Member State can prefer to make a public offering of shares to retail investors and to institutional investors while retaining a controlling stake. Alternatively, the government can combine a trade sale with a public offering.

Mixing a public offering with a trade sale or a sale to knowledgeable institutional investors can reduce underpricing. Furthermore, the sale of shares to trade buyers or institutional investors can contribute to better control and a better governance structure.

10.4 Mergers and Divisions

10.4.1 General Remarks

A merger and a division can lead to a share exchange or a clean exit or a combination of cash payment and securities. Mergers and divisions differ from private sales and takeover offers in that the shareholder may not choose whether to sell shares or not. Shareholders vote on the merger or division. Upon the transaction becoming effective, it will be binding on all shareholders, irrespective of whether or not they attended or voted at the general meeting. Shareholders will therefore need to be protected in many ways. Formation of a holding SE under the SE Regulation is an alternative to a merger.

10.4.2 Mergers

Formal mergers were already discussed in section 5.11.4 above. It is characteristic of mergers that a company is dissolved without going into liquidation and that the company transfers to another all its assets and liabilities in exchange for the issue to its shareholders of shares in the other company and/or a cash payment and/or a

consideration other than in cash.[181] A merger can thus lead to a share exchange or a clean exit or the exchange of shares for a combination of cash and securities. Shareholders do not decide on the sale of their shares to the surviving entity as shares are not sold, but shareholders can vote on the merger.

Friendly mergers. A merger is always friendly. According to the Third Company Law Directive, a merger requires the approval of the general meeting of each of the merging companies.[182] However, there is no merger without draft terms of merger, that is, an agreement between the boards of the participating companies. Shareholders thus have a veto right provided that the boards already have agreed on the merger.

The administrative or management bodies of the participating companies must draw up draft terms of merger in writing.[183] In addition, the Third Company Law Directive requires a written report drawn up by the administration or management bodies of each of the merging companies[184] and a written report drawn up by independent experts such as certified auditors.[185] Shareholders must be able to inspect all such documents at least one month before the general meeting.[186] Draft terms of merger must be published at least one month before the date fixed for the general meeting which is to decide on the merger.[187]

Case: Takeover of Scottish & Newcastle. The takeover of Scottish & Newcastle is an example of a clean exit through a merger and of friendliness as a necessary condition of mergers.

In the Scottish & Newcastle case, Carlsberg A/S and Heineken N.V. first made a highly conditional proposal to Scottish & Newcastle plc to make a cash offer for Scottish & Newcastle.[188]

The proposal was not a cash offer to the shareholders of Scottish & Newcastle. Furthermore, it was subject to a number of pre-conditions, including a recommendation by the board of Scottish & Newcastle and extensive due diligence.

Scottish & Newcastle rejected the proposal on the same day.[189] A second proposal was rejected on the same day it was made.[190]

Finally, the Takeover Panel imposed a deadline of 21 January 2008 for Carlsberg and Heineken (the Consortium) to launch a formal offer or withdraw ("Put up or Shut up deadline"). By then, those two companies would have had three months to actually make a public offer to the shareholders of Scottish & Newcastle.[191]

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[181] Articles 3(1) and 4(1) of Directive 78/855/EEC (Third Company Law Directive); Article 2(2) of Directive 2005/56/EC (Directive on cross-border mergers).
[182] Article 7(1) of Directive 78/855/EEC (Third Company Law Directive).
[183] Article 5(1) of Directive 78/855/EEC (Third Company Law Directive).
[184] Article 9(1) of Directive 78/855/EEC (Third Company Law Directive).
[185] Article 10(1) of Directive 78/855/EEC (Third Company Law Directive).
[186] Article 11(1) of Directive 78/855/EEC (Third Company Law Directive).
[187] Article 6 of Directive 78/855/EEC (Third Company Law Directive).
[188] Scottish & Newcastle plc, stock exchange release of 25 October 2007.
[189] Scottish & Newcastle plc, stock exchange release of 25 October 2007.
[190] Scottish & Newcastle plc, stock exchange release of 15 November 2007.
[191] Scottish & Newcastle plc, stock exchange release of 17 December 2007.

A third proposal was made to Scottish & Newcastle on 9 January 2008 and rejected on the following day.[192] Some progress was nevertheless made. Scottish & Newcastle notified that its board was now prepared to engage with the Consortium, but "only when a firm proposal of at least 800 pence per share had been made and when Carlsberg has agreed to the publication of proper information about BBH prospects".

On 17 January 2008, the parties confirmed that they had entered into discussions in relation to a possible recommended offer for Scottish & Newcastle at 800 pence per share. As no formal offer had been made at this stage, the parties approached the Takeover Panel to request a short extension to the Put up or Shut up deadline to enable the Consortium to complete its due diligence,[193] and a further short extension.[194]

On 25 January 2008, the boards of Sunrise Acquisitions Limited ("BidCo") and Scottish & Newcastle plc finally announced that they had reached agreement on the terms of a recommended cash offer to be made by BidCo, a newly incorporated company jointly owned by Carlsberg and Heineken, for the entire issued and to be issued share capital of Scottish & Newcastle. Under the terms of the offer, shareholders would receive 800 pence in cash for each Scottish & Newcastle share.[195] The participating companies agreed on what can be called a dual-track merger, that is, a merger track and an option to make a takeover offer.

The first track was thus the merger track. The offer was to be implemented by way of a court-sanctioned scheme of arrangement under section 425 of the Companies Act 2006. The procedure involved an application by Scottish & Newcastle to the court to sanction the scheme. Before the final court order could be sought, the scheme required the consent of shareholders at general meeting. Scottish law required a majority of not less than three-fourths of votes in favour of the scheme. The scheme would become effective upon sanction by the court and registration of the final court order by the registrar of companies. Upon the scheme becoming effective, it was binding on all scheme shareholders, irrespective of whether or not they attended or voted at the court meeting or the extraordinary general meeting.

Just in case, the parties agreed that BidCo had an option to implement the offer by way of a takeover offer on the same terms so far as applicable. After a takeover offer, BidCo would have applied the provisions of sections 979 to 982 of the Companies Act 2006 to acquire compulsorily any outstanding Scottish & Newcastle shares. Agreement on the second track was subject to the consent of the Panel on Takeovers and Mergers.

Directive on takeover bids. The case of Scottish & Newcastle shows that a merger offer can be a functional equivalent to a takeover bid. However, it would be difficult to apply the Directive on takeover bids to mergers.

The Third Company Law Directive lays down the disclosure obligations of the participating companies' boards and the powers of the general meeting to decide

[192] Scottish & Newcastle plc, stock exchange release of 10 January 2008.
[193] Scottish & Newcastle plc, stock exchange release of 17 January 2008.
[194] Scottish & Newcastle plc, stock exchange release of 24 January 2008.
[195] Scottish & Newcastle plc, stock exchange release of 25 January 2008.

on the merger. Usually, a merger must be sanctioned by the court.[196] This also means that there would be hardly any room for the application of the provisions of the Directive on takeover bids where a participating company that will not survive the merger has issued shares admitted to trading on a regulated market.

Although the Directive on takeover bids does not explicitly exclude mergers from its scope, the wording of that Directive implies that it does not apply where the offeree company ceases to exist as a legal entity as a result of the transaction of which the offer is part.[197]

On the other hand, it would, in practice, be possible to apply the general principles set out in the Directive on takeover bids even in the context of mergers,[198] as well as to require the disclosure of information according to the principles that apply to offer documents under the Directive.[199] Such provisions might therefore influence the interpretation of board duties under the Third Company Law Directive in the context of a merger. This is supported by the principle that provisions of Community law should not be given a meaning that frustrates the application of other provisions of Community law.

Valuation. Rules on the valuation of shares and the exchange ratio are important, because a shareholder cannot choose whether to sell his shares or not in the event that a sufficient majority has voted for the merger. The main rules on the valuation of shares and the exchange ratio under EU merger law are disclosure rules.

The draft terms of merger must specify the share exchange ratio and the amount of any cash payment.[200] The written report drawn up by the administration or management bodies of each of the merging companies must set the share exchange ratio and describe any special valuation difficulties which have arisen.[201]

In their own report, independent experts must state whether in their opinion the share exchange ratio is fair and reasonable. Their statement must at least: (a) indicate the method or methods used to arrive at the share exchange ratio proposed; (b) state whether such method or methods are adequate in the case in question, indicate the values arrived at using each such method and give an opinion on the relative importance attributed to such methods in arriving at the value decided on. The report must also describe any special valuation difficulties which have arisen.[202]

Remedies for dissenting shareholders. In addition to disclosure, a mix of remedies is available to shareholders depending on the jurisdiction.

First, shareholders can *vote* against the merger.

Second, they may, at least in some jurisdictions, have a right to *contest* the resolution of the general meeting on certain grounds. Such proceedings can result

[196] Articles 13 and 16 of Directive 78/855/EEC (Third Company Law Directive).
[197] See Article 2(1)(a) of Directive 2004/25/EC (Directive on takeover bids).
[198] See Article 3 of Directive 2004/25/EC (Directive on takeover bids).
[199] See Articles 6(2) and 6(3) of Directive 2004/25/EC (Directive on takeover bids).
[200] Article 5(2)(b) of Directive 78/855/EEC (Third Company Law Directive).
[201] Article 9 of Directive 78/855/EEC (Third Company Law Directive).
[202] Article 10(2) of Directive 78/855/EEC (Third Company Law Directive).

in the nullity of the merger. The Third Company Law Directive permits Member States to adopt such rules but restricts their use.[203]

Typically, the rights of shareholders to contest merger resolutions have been limited because of a high risk of abuse and hold-up.[204]

For example, the liberal rights of shareholders to contest resolutions under German law have enabled a small number of professional litigants (Berufskläger) to earn a living by threatening to block mergers and other corporate transactions (section 19.10).

Where an SE has been formed by means of a merger, the merger may not be declared null and void once the SE has been registered.[205] There is a similar rule for cross-border mergers that fall within the scope of the Directive on cross-border mergers.[206]

Third, the national provisions of Member States' laws can provide for particular *appraisal rights*. The appraisal remedy means that dissenting shareholders are given the right to have the fair value of their shares determined and paid to them in cash, provided that the shareholders follow the statutory procedure.[207]

EU merger law does not require such a remedy. However, Member States are free to adopt the appraisal remedy in the light of the Third Company Law Directive and the SE Regulation.[208]

Appraisal rights can be found both in common law as well as in civil law countries. Appraisal rights typically mean the right of a shareholder to have the company redeem all shares owned by that shareholder if the shareholder did not vote in favour of the merger. The procedure is based on company law. However, there is normally no specific valuation method specified by statute.

In Germany, the Aktiengesetz and the Umwandlungsgesetz (the Transformation of Companies Act) give a shareholder the right to adequate cash compensation.[209]

The Third Directive further provides that shareholders must be protected by rules on the *civil liability* of the members of the administrative or management bodies of the company and the independent experts for breach of duty.[210] However, the Third Directive does not say how the shares should be valued and how exactly the persons responsible for information about valuation in the reports should be liable

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[203] Article 22 of Directive 78/855/EEC (Third Company Law Directive).
[204] See, for example, § 14 UmwG and § 34 UmwG.
[205] Article 30 of Regulation 2157/2001 (SE Regulation).
[206] Article 17 of Directive 2005/56/EC (Directive on cross-border mergers).
[207] See Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 192–193.
[208] Article 28 of Directive 78/855/EEC (Third Company Law Directive); Articles 24(2) and 25(3) of Regulation 2157/2001 (SE Regulation). See also Siems MM, SEVIC: Beyond Cross-Border Mergers, EBOLR 2007 p 309.
[209] See § 15(1) UmwG, § 29(1) UmwG, and § 34 UmwG.
[210] Articles 20–21 of Directive 78/855/EEC (Third Company Law Directive).

to shareholders for breach of duty. In practice, the appraisal remedy is more important for shareholders in the company that will not survive the merger.

Prospectus Directive. A merger can trigger a duty to publish a prospectus under the Prospectus Directive or a document equivalent to that of a prospectus.

The main rule under the Prospectus Directive is that (1) securities may not be offered to the public without prior publication of a prospectus approved by the competent authority of the home Member State[211] and that (2) any admission of securities to trading on a regulated market within the Community is subject to the publication of a prospectus.[212] However, there are exemptions from the obligation to publish a prospectus under the Prospectus Directive.

The obligation to publish a prospectus under the Prospectus Directive does not apply, if the securities are "offered, allotted or to be allotted in connection with a merger, provided that a document is available containing information which is regarded by the competent authority as being equivalent to that of the prospectus, taking into account the requirements of Community legislation".[213]

Neither does the obligation to publish a prospectus under the Prospectus Directive apply to admission to trading on a regulated market, if the securities are "securities offered, allotted or to be allotted in connection with a merger, provided that a document is available containing information which is regarded by the competent authority as being equivalent to that of the prospectus, taking into account the requirements of Community legislation."[214]

The relationship between the Third Directive and the Prospectus Directive can be illustrated by the case of Mittal and ArcelorMittal. The merger of Mittal and ArcelorMittal is also an example of a merger where the holdings of shareholders in one company are converted into holdings in another company.

Case: Mittal Steel and ArcelorMittal. In 2007, Mittal Steel Company N.V., a company incorporated under Dutch law, merged into ArcelorMittal S.A, its wholly-owned non-operating subsidiary founded under the laws of Luxembourg, in the first step of the two-step merger process between Mittal Steel and Arcelor. The merger documentation comprised: a merger proposal; an explanatory memorandum; a European prospectus; as well as a US proxy statement and prospectus.

The merger proposal was required by Dutch and Luxembourg corporate law. The provisions of those laws were based on the provisions of the Third Company Law Directive that require the drawing up and publication of draft terms of merger.[215] As both the Third Directive and the provisions of Dutch and Luxembourg law were designed for domestic mergers, the participating companies relied on the judgment of the ECJ in *Sevic Systems*.[216] (The deadline for the implementation of the provisions of the Directive on cross-border mergers was later.[217])

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[211] Articles 3(1) and 13(1) of Directive 2003/71/EC (Prospectus Directive).
[212] Article 3(3) of Directive 2003/71/EC (Prospectus Directive).
[213] Article 4(1)(c) of Directive 2003/71/EC (Prospectus Directive).
[214] Article 4(2)(d) of Directive 2003/71/EC (Prospectus Directive).
[215] Articles 5(1) and 6 of Directive 78/855/EEC (Third Company Law Directive).
[216] Case C-411/03 Sevic Systems [2005] ECR I-10805.
[217] Article 19 of Directive 2005/56/EC (Directive on cross-border mergers).

The Third Directive and therefore also Dutch and Luxembourg corporate law required the drawing up of a written report. The explanatory memorandum fulfilled this requirement.[218]

The merger proposal (draft terms of merger) and the explanatory memorandum (report) were regarded as equivalent to a prospectus when ArcelorMittal offered its shares to the shareholders of Mittal Steel.[219] ArcelorMittal did not publish any prospectus at this stage.

However, they would not have been regarded as equivalent to a prospectus when ArcelorMittal applied for the admission of its shares to trading on a regulated market. ArcelorMittal therefore published a European prospectus for European shareholders under the Prospectus Directive before the ArcelorMittal shares issued in the first-step merger could be admitted to trading on regulated markets.

In addition to the European prospectus, ArcelorMittal published a US proxy statement and a prospectus for US shareholders.

Cross-border mergers. Cross-border mergers differ from domestic mergers because the shareholders, creditors and employees of the company that will not survive the merger will not only become shareholders, creditors and employees of a different company but also of a company governed by the laws of a different country. More extensive protection may therefore be granted under Community law.[220] For example, the legality of a cross-border merger will be scutinised in advance by a competent authority.[221] A competent authority will also scrutinise the legality of the completion of the cross-border merger.[222]

Cash-out mergers, releasing capital. As said above, the merger consideration can consist of shares in the company that will survive the merger and/or a cash payment.[223]

The surviving company or its shareholders may use cash-out mergers as a means to get rid of minority shareholders. For this reason, cash-out mergers are sometimes called "squeeze-out mergers" or "freeze-out mergers".[224]

From the perspective of the target's shareholders, cash-out mergers are a way to release capital. This can be illustrated by the Boxclever case.

Case: Boxclever. In 1999, both Granada and Nomura owned struggling TV rentals businesses in the UK. They decided to merge them in order to create savings and to cash in as much of their investment as possible. The transaction was completed in 2000.

A new company, Boxclever, was formed to acquire the businesses. Granada and Nomura maintained a 50/50 shareholding in the company.

The deal was financed by Boxclever borrowing £860 million from WestLB, a German bank. Granada took £511 million in cash, of which about £200 million

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[218] Article 9(1) of Directive 78/855/EEC (Third Company Law Directive).
[219] Article 4(1)(c) of Directive 2003/71/EC (Prospectus Directive).
[220] Siems MM, SEVIC: Beyond Cross-Border Mergers, EBOLR 2007 p 309.
[221] Article 10 of Directive 2005/56/EC (Directive on cross-border mergers).
[222] Article 11 of Directive 2005/56/EC (Directive on cross-border mergers).
[223] Articles 3(1) and 4(1) of Directive 78/855/EEC (Third Company Law Directive); Article 2(2) of Directive 2005/56/EC (Directive on cross-border mergers).
[224] See Groner R, Barabfindungsfusion (Cash Out-Merger), SJZ 99 (2003) pp 393–402.

was profit, while Nomura took about £330 million, of which about £140 million was profit. WestLB's fees were about £20 million.

The story did not end there. WestLB's credit exposure was now £860 million. The parties intended to restructure Boxclever's loans and shift the loan off WestLB's balance sheet. The balance of the original £860m loan was converted into mezzanine debt. A £748 million securitisation followed. Boxclever issued notes secured against the income from Boxclever's TV rental business. However, WestLB was unable to sell the notes to other investors and had to hold £528 million of the note issue on its own balance sheet. Even worse, it turned out that Boxclever could not service its heavy debts. In 2003, Boxclever defaulted. Later, it went bankrupt. In 2005, an acquisition vehicle established by Fortress and Cerberus (and their related funds) acquired the outstanding notes and other assets for £200 million in a complex transaction. WestLB lost about €430 million in write-offs. The transaction led to criminal charges in Germany (Untreue). In addition, a French bank sued CIBC and WestLB which had acted as co-lead managers in the securitisation transaction for breach of duty of care.

10.4.3 Formation of a Holding SE

The SE Regulation is flexible in that it enables companies from different Member States to merge, to create a holding company, or to form joint subsidiaries. Formation of a holding SE is one of the four ways to establish an SE under the SE Regulation.[225] It can sometimes be an economic equivalent to a merger.

Continued existence of participating companies. Unlike in a merger, the companies that participate in the formation of a holding SE will not cease to exist but become subsidiaries of the holding SE.[226] This also explains why a Member State may not oppose the formation of a holding SE on grounds of public interest although it may oppose the formation of an SE by merger.[227]

Friendly transaction. Like a merger, the formation of a holding SE is always friendly. The holding SE will not be formed, unless draft terms are first drawn up by the management or administrative organs of the participating companies.[228] A written report must be drawn up by independent experts for their shareholders.[229] The general meeting of each company promoting the operation will have a veto right.[230]

Consideration. Shareholders who have contributed their securities to the formation of the SE will receive shares in the holding SE.[231]

Valuation. The main rule on valuation is a disclosure rule. Draft terms for the formation of the holding SE must include "a report explaining and justifying the

[225] Recital 10 and Articles 2(2) and 32 of Regulation 2157/2001 (SE Regulation).
[226] Article 32(1) of Regulation 2157/2001 (SE Regulation). For companies that may participate, see Article 2(2) and Annex II of Regulation 2157/2001 (SE Regulation).
[227] Article 19 of Regulation 2157/2001 (SE Regulation).
[228] Article 32(2) of Regulation 2157/2001 (SE Regulation).
[229] Article 32(4) of Regulation 2157/2001 (SE Regulation).
[230] Article 32(6) of Regulation 2157/2001 (SE Regulation).
[231] Article 33(4) of Regulation 2157/2001 (SE Regulation).

legal and economic aspects of the formation and indicating the implications for the shareholders" as well as the share-exchange ratio, the amount of any compensation, and the terms for the allotment of shares in the SE. The report drawn up by independent experts for each company must indicate "any particular difficulties of valuation and state whether the proposed share-exchange ratio is fair and reasonable, indicating the methods used to arrive at it and whether such methods are adequate in the case in question".

Remedies for dissenting shareholders. In addition to disclosure, a mix of remedies is available to shareholders depending on the jurisdiction.

First, shareholders can vote against approval of the draft terms of formation of the holding SE.[232]

Second, the SE Regulation permits Member States to "adopt provisions designed to ensure protection for minority shareholders who oppose the operation, creditors and employees".[233] For example, shareholders might, at least in some jurisdictions, contest the resolution of the general meeting authorising the transaction.

Third, unlike in mergers, a shareholder can choose whether to remain shareholder of the promoting company or to become shareholder of the holding SE: "The shareholders of the companies promoting such an operation shall have a period of three months in which to inform the promoting companies whether they intend to contribute their shares to the formation of the holding SE."[234]

Shareholders who have contributed their securities to the formation of the SE shall receive shares in the holding SE.[235] The holding SE shall be formed only if the shareholders of the companies promoting the operation have assigned the minimum proportion of shares in each company in accordance with the draft terms of formation and if all the other conditions are fulfilled.[236]

10.4.4 Divisions

Divisions are a particular form of exit. In a division, the assets and liabilities of one company (the company being divided) are transferred to two or more companies (the recipient companies). The shareholders of the company being divided become shareholders of one or more of the recipient companies. The company being divided ceases to exist. Alternatively, the divided company retains its remaining assets and continues to exist.[237]

Functional equivalents to divisions. Divisions that are divisions in the legal sense are not as usual as mergers, and many divisions are functional equivalents to divisions rather than divisions in the legal sense.

[232] Article 32(6) of Regulation 2157/2001 (SE Regulation).
[233] Article 34 of Regulation 2157/2001 (SE Regulation).
[234] Article 33(1) of Regulation 2157/2001 (SE Regulation).
[235] Article 33(4) of Regulation 2157/2001 (SE Regulation).
[236] Article 33(2) of Regulation 2157/2001 (SE Regulation).
[237] Article 17 of Directive 82/891/EEC (Sixth Company Law Directive).

A division is often connected to internal structural change in which a subsidiary is split into two or more companies still owned by the parent. The motive may be to make individual businesses within the group more transparent or to sell one of the new companies.[238]

In recent years, divisions have also been applied as a means to increase share price. If conglomerate companies are not in fashion, conglomerate discount can be reduced and the valuation of shares increased by focusing on core business areas. This can be achieved through the sale of businesses or through a division.[239]

Some transactions resemble divisions of companies in the economic sense without being divisions in the legal sense. (a) For example, a company can distribute shares in a subsidiary to its own shareholders as a dividend. In 2008, Motorola announced that it would split into two independent companies in 2009. One business would concentrate on making mobile phones, while the second would make television set-top boxes and other communications equipment. The split took the form of a tax-free distribution to Motorola's shareholders, resulting in shareholders holding shares of two independent and publicly-traded companies. (b) In addition, a joint-venture project can be terminated in many ways without the project company being wound-up or divided.

In EU tax law, the Directive 90/434/EEC on the taxation of mergers was modified by Directive 2005/19/EC in order to enable tax neutral divisions.[240]

Divisions and ownership structure. One of the possible reasons to use divisions is the need to change the share ownership structure of the company. This can be illustrated by the following three Finnish divisions.

- Unchanged share ownership structure. Antti Ahlström Osakeyhtiö was an old family-owned Finnish conglomerate. The origins of the business of Ahlström dated to 1851. The company eventually ended up owning a wide range of assets. In 2001, the company was split into three newly-formed companies.[241] Family shareholders kept their holdings in all three companies: Ahlstrom Corporation (an industrial company that later became listed after an IPO); Ahlström Capital Oy (a privately-owned investment company); and A. Ahlström Osakeyhtiö (a privately-owned company with long-term forestry and real estate assets).
- Separation of shareholder blocks. Kone Corporation was a listed company controlled by a family that had been divided into two shareholder blocks. The shareholder blocks decided to part their ways. In 2005, Kone Corporation was divided into two listed companies. One shareholder block ended up with control of (new) Kone, and the other with control of Cargotec.
- Takeover or reverse takeover. Founded in 1886, John Nurminen Oy was a large privately-owned company. In 2007, John Nurminen Oy was divided. In a rever-

[238] Werlauff E, EU Company Law. Second Edition. DJØF Publishing, Copenhagen (2003) pp 586–587.
[239] *Ibid.*
[240] See Article 2(b)(a) of Directive 2005/19/EC.
[241] See Article 21 of Directive 82/891/EEC (Sixth Company Law Directive).

se takeover, its logistics operations were acquired by Kasola Oyj, a small listed company that issued shares to the shareholders of John Nurminen Oy as consideration for the division of John Nurminen Oy. Kasola Oyj thus paid for the logistics operations by issuing its shares to the shareholders of John Nurminen Oy and ended up being controlled by John Nurminen's shareholders. Kasola Oyj changed its name into Nurminen Logistics Oyj.

Friendly divisions. A division is always friendly. According to the Sixth Company Law Directive, there will be no division unless the administrative or management bodies of the companies involved in a division draw up draft terms of division[242] and the division is approved by the general meeting of each company involved in the division.[243] In a division by the formation of new companies,[244] the draft terms of division and the memorandum or draft memorandum of association and the articles or draft articles of association of each of the new companies will be approved at a general meeting of the company being divided.[245]

Like the Third Company Law Directive, the Sixth Directive requires draft terms of division drawn up by the administrative or management bodies of the participating companies in writing,[246] a written report drawn up by the administration or management bodies of each of the participating companies,[247] and a written report drawn up by independent experts such as certified auditors.[248] Shareholders must be able to inspect all such documents at least one month before the general meeting.[249] Draft terms of division must be published at least one month before the date fixed for the general meeting which is to decide on the division.[250]

Protection of shareholders. Because of the legal nature of divisions, it is necessary to protect shareholders and creditors in all participating companies. The division affects also those shareholders who have voted against it. There must be legal rules on the distribution of assets and liabilities, the valuation of shares, and consideration for shares or assets. According to the Sixth Company Law Directive, the main rule on the distribution of assets and liabilities, the valuation of shares, and the exchange ratio is disclosure.

Consideration. It is characteristic of divisions that shareholders of the company being divided receive shares in the recipient companies and/or a cash payment.[251] Draft terms of division must specify the share exchange ratio and the amount of any cash payment.[252]

[242] Article 3 of Directive 82/891/EEC (Sixth Company Law Directive).
[243] Article 5(1) of Directive 82/891/EEC (Sixth Company Law Directive).
[244] Article 21(1) of Directive 82/891/EEC (Sixth Company Law Directive).
[245] Article 22(3) of Directive 82/891/EEC (Sixth Company Law Directive).
[246] Article 3(1) of Directive 82/891/EEC (Sixth Company Law Directive).
[247] Article 7(1) of Directive 82/891/EEC (Sixth Company Law Directive).
[248] Article 8(1) of Directive 82/891/EEC (Sixth Company Law Directive).
[249] Article 9 of Directive 82/891/EEC (Sixth Company Law Directive).
[250] Article 4 of Directive 82/891/EEC (Sixth Company Law Directive).
[251] Article 2(1) of Directive 82/891/EEC (Sixth Company Law Directive).
[252] Article 3(2)(b) of Directive 82/891/EEC (Sixth Company Law Directive).

As a rule, there must be equivalent treatment of shareholders in the same position. In Community law, the principle of equivalent treatment can be based on the Second Company Law Directive and the Takeover Directive as well Member States' company laws. The Sixth Company Law Directive does not require equivalent treatment as such.[253]

The Third Company Law Directive and the Sixth Company Law Directive provide that one one consequence of a division (or a merger) is that shareholders of the company being divided (or the company that will not survive the merger) automatically become shareholders of the recipient companies (or the company that will survive the merger). In practice, this may not always be the case in so-called "trilateral divisions" (or "trilateral mergers"). In a trilateral division (or a trilateral merger), consideration may in practice consist of shares in a third company. In 2002, the EFTA Surveillance Authority asked Norway to comply with those two Company Law Directives. In the Authority's view, the Norwegian legislative provisions on "trilateral mergers" and "trilateral divisions" did not ensure a proper protection of shareholders.[254]

Allocation of assets. Consideration depends on the allocation of assets and liabilities. Draft terms of merger must also specify: the precise description and allocation of the assets and liabilities to be transferred to each of the recipient companies; and the allocation to the shareholders of the company being divided of shares in the recipient companies and the criterion upon which such allocation is based.[255]

Valuation. The Sixth Company Law Directive does not set out how shares and assets should be valued. In any case, the written report drawn up by the administration or management bodies of the participating companies must explain the draft terms of division and set out the legal and economic grounds for them, in particular the share exchange ratio and the criterion determining the allocation of shares. The report must also describe any special valuation difficulties which have arisen.[256] Valuation questions will also be discussed in the report drawn up by independent experts.[257]

Remedies for dissenting shareholders. Like in mergers, a mix of remedies is available to shareholders depending on the jurisdiction.

First, shareholders can vote against the division. As the decision to approve of a division requires a qualified majority, a large block of minority shareholders may be able to block the division.[258]

Second, they can, at least in some jurisdictions, contest the resolution of the general meeting approving of the division. Such proceedings can result in the nullity of the division. The Sixth Company Law Directive permits Member States to adopt such rules but restricts their use. It is the purpose of the Sixth Directive to

[253] See Article 5(2) of Directive 82/891/EEC (Sixth Company Law Directive).
[254] The EFTA Surveillance Authority, Press Release PR(02)16.
[255] Article 3(2) of Directive 82/891/EEC (Sixth Company Law Directive).
[256] Article 7 of Directive 82/891/EEC (Sixth Company Law Directive).
[257] Article 8 of Directive 82/891/EEC (Sixth Company Law Directive).
[258] Article 5(1) of Directive 82/891/EEC (Sixth Company Law Directive) and Article 7 of Directive 78/855/EEC (Third Company Law Directive). See also Article 20 of Directive 82/891/EEC (Sixth Company Law Directive).

"ensure certainty in the law as regards relations between the companies involved in the division, between them and third parties, and between the members".[259] The Directive limits the cases in which nullity can arise by providing that defects be remedied wherever that is possible and by restricting the period within which nullification proceedings may be commenced.[260]

Third, the Sixth Company Law Directive requires rules governing the civil liability of members of the administrative or management bodies of the company being divided and the civil liability of the experts responsible for drawing up the report.[261]

However, the Sixth Company Law Directive is silent on the particular exit rights of dissenting shareholders (appraisal rights). On one hand, there are similarities between mergers and divisions, and it is the purpose of the Sixth Company Law Directive to ensure that the safeguards laid down by the Third Company Law Directive will not be circumvented. On the other, the Third Company Law Directive only permits the existence of appraisal rights but does not require them, and there is a fundamental difference between mergers and divisions. Appraisal rights are more feasible in mergers, because mergers result in one surviving company. They are less feasible in divisions, because divisions result in two or more surving companies and the allocation of assets and liabilities must be regulated in detail in advance. Under German law, an appraisal right exists in mergers[262] but not in divisions.

Protection of creditors. According to the Sixth Directive, holders of securities other than shares must be given rights at least equivalent to the rights they possessed in the company being divided.[263]

In addition, the laws of Member States must provide for an adequate system of protection for the interests of existing creditors. For example, the recipient companies can be made jointly and severally liable for a transferred obligation; the adoption of such a duty is nevertheless optional.[264]

Prospectus Directive. A division can trigger a duty to publish a prospectus under the Prospectus Directive. Unlike mergers, divisions have not been mentioned in the Prospectus Directive. The main rules on the obligation to publish a prospectus will therefore apply.

Cross-border divisions. There is no directive on cross-border divisions supplementing the Directive on cross-border mergers. The High Level Group of Company Law Experts did not find such a directive necessary in its 2002 Final Report.[265]

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[259] Recital 11 of Directive 82/891/EEC (Sixth Company Law Directive).

[260] Article 19 of Directive 82/891/EEC (Sixth Company Law Directive).

[261] Article 18 of Directive 82/891/EEC (Sixth Company Law Directive).

[262] § 29(1) UmwG.

[263] Article 13 of Directive 82/891/EEC (Sixth Company Law Directive).

[264] See Article 12 of Directive 82/891/EEC (Sixth Company Law Directive).

[265] Final Report of the High Level Group of Company Law Experts (2002) p 108: "We doubt the need for this, given the possibility for parts of a business to be hived off into separate subsidiaries preparatory to disposal by merger …"

On the other hand, the judgment of the ECJ in *Sevic* can easily be applied even to cross-border divisions. In the light of *Sevic*, cross-border divisions cannot be prohibited as such. However, in the absence of a directive on cross-border divisions, the exact manner in which cross-border divisions are undertaken and how shareholders, creditors and employees are protected is still open. Member States should preferably adopt specific rules for cross-border divisions. In the absence of such rules, it is for the courts to decide how cross-border divisions can take place.[266]

10.5 Private Equity and Refinancing

A private-equity firm (or a private-equity fund) is a firm that is in the business of leveraged buyouts of privately-owned or listed companies. The private equity industry has developed refinancing as a way to finance the takeover from the assets of the target and to increase returns. Exit is a core component of the business model of private-equity firms.

Private-equity firms have influenced the financial decision-making of large firms. One of the reasons why listed companies tend to have extensive share buy-back programmes is the need to react to the threat of being taken over. The distribution of assets to existing shareholders in advance can make a threatening LBO more expensive for the buyer, as it would be more difficult for the target to repay the buyer's short-term loans after the takeover. For the same reason, listed companies tend to own only their core assets and choose a high debt-to-equity ratio.

Private equity fund. The first step in the business model of private-equity firms is to raise equity capital for the fund. The fund will usually be a limited partnership.

In a limited partnership, most questions can be based on contract. There is no mandatory legal capital regime. It will therefore be easy to make payments to investors. Investors may use a holding company with limited liability in order to reduce legal risk or for tax purposes.

The private-equity firm will usually be the management firm and the general partner that has unlimited liability; however, the private-equity firm will be shielded against unlimited liability by means of a holding company.

The management firm will receive a management fee and a percentage of the profits. The management firm (the general partner) might invest some equity capital in the fund (1%-3%). The rest will come from investors (limited partners). The management firm will charge an annual management fee on committed capital (1%-2.5%) as well as a bonus (carried interest, typically up to 20% of the profits). Carried interest becomes payable once the investors have achieved repayment of their original investment in the fund, plus a defined hurdle rate (perhaps 6%-10%).[267]

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[266] Siems MM, SEVIC: Beyond Cross-Border Mergers, EBOLR 2007 pp 314–315.
[267] Rudolph B, Funktionen und Regulierung der Finanzinvestoren, ZGR 2008 p 177.

The financial rewards of the management firm thus depend on volume, and the fee structure gives an incentive to use very high leverage.

For example, LTCM raised plenty of money from investors, took big positions, and used extreme leverage. The partners of the management firm took 25% of the profits in addition to a yearly 2% charge on assets and required that investors commit for at least three years (lock-up).[268]

Business model of private-equity firms. Apart from fees, the business model of private-equity firms consists of a highly leveraged buy-out (LBO) combined with refinancing and exit.

Refinancing has two core functions. First, it enables the buyer to finance the takeover from the assets of the target. Second, refinancing enables the buyer to release capital after the takeover and distribute assets to investors.

Because of high leverage, investors can earn a high return on the capital that they have invested – at least in the short term and provided that everything goes according to plan.

Steps of refinancing. Refinancing consists of three or four main steps.

First, the buyer (for example, a private-equity firm) founds a new company and calls it, for example, Newco. Newco raises a loan and buys all shares in the target company. After a successful leveraged takeover, Newco and the target company will be combined in a merger into a single corporate entity. After the merger, all property owned by each constituent company is vested in the surviving company. It is just as important that all liabilities of each constituent company are vested in the surviving company. The loan originally raised by Newco will then be repaid from assets that originally belonged to the target company.

Second, the assets that can be distributed to shareholders (in this case, the private-equity firm) will be increased by reducing share capital to the legal minimum. Distributions to shareholders will be financed in many ways: by selling off assets such as subsidiaries, plants and real estate; by reducing costs, for example research and development costs; and by raising new loans.

Third, the second step can be repeated. The company will distribute as much as it legally can to shareholders.

The last step will be exit. As the owners (the private-equity firm) have already profited from the repayment of loans from assets that originally belonged to the target and from the distribution of its distributable assets, the price that outsiders are prepared to pay for the shares is less crucial than in normal share sales. – This technique can also be described as follows.

[268] Lowenstein R, When Genius Failed. The Rise and Fall of Long-Term Capital Management. Fourth Estate, London (2001) p 27.

Table 10.1. Refinancing

(1) Acquisition

- The private-equity firm founds a holding company and invests some equity capital in it.
- The holding company borrows a lot of money (bridge loan) in order to buy all shares in the target company. A high gearing increases return on equity invested by the private-equity firm.
- If all shareholders have not sold their shares, the holding company will use the squeeze-out mechanism.
- The holding company has now obtained all shares in the target company.
- If the target is a listed firm, it is taken private.
- The private-equity firm wants the holding company to repay the bridge loan from the assets of the target company. The question is how, because distributions to shareholders are heavily restricted.

(2) First round of refinancing

- The first round of refinancing starts.
- The holding company can make the target company distribute all distributable assets in the form of dividends; and the holding company can distribute assets to the private-equity firm.
- The holding company and the target company merge. After the merger, the debts of the holding company and the assets of the target company are the debts and assets of the same company (henceforth "the new company"). The bridge loan can therefore be repaid from assets that used to belong to the target company.
- The new company is loaded with debt. It must sell assets in order to cope. Assets are sold as a going concern, but assets can also be sold in other ways: sale and lease-back of buildings and real estate and machines etc, securitisation of receivables, the closure of factories and the sale of production assets.
- Short-term debt is replaced by long-term debt.

(3) Second round of refinancing

- There can also be a second round of refinancing.
- The new company can borrow more money.
- This again enables the new company to distribute all possibly distributable assets to the sole shareholder.

(4) Exit phase

- Exit phase is the final phase.
- The new company can issue shares and bonds in order to reduce debt or finance growth.
- The new company can become listed again: the venture capital firm sells shares in an IPO.
- The price that the private-equity firm will receive for the new company's shares does not have to be higher than the price that the holding company paid for shares in the target, because assets have already been distributed to the private-equity firm as dividends.
- Refinancing is therefore an important part of the business plan of the private equity capital firm.

Legal aspects. Refinancing is an effective way not only to release capital but also to distribute funds from the target to its new owners. Refinancing is nevertheless constrained by legal rules. The most important legal constraints can be found in company law and insolvency law. In addition, tax considerations can play an important role.

Insolvency law is relevant because of the high gearing of the target company after the formal merger with the holding company and after one or more rounds of refinancing. If the target becomes insolvent, there is a high risk that payments made by the target to the owners will be reversed and must be returned in insolvency proceedings (see Volume II).

Company laws typically provide that transactions that are necessary for refinancing require decisions by the board. Refinancing is not possible without a friendly board.

Company laws also provide that the board of the target owes its duties to that company and not to its shareholders (section 17.2). In particular, the board members owe a general duty of care and fiduciary or similar duties to the company. On the other hand, it is characteristic of refinancing to change the time perspective of the target. Instead of investing in the long term, the target company will be expected to serve the short-term interests of its new owners and maximise their cash flow in the short term.[269] The target will typically be left loaded with debt. There can therefore be a conflict between the legal duties of the target's board members and what the private-equity firm tells them to do.

In addition, refinancing is constrained by the European legal capital regime (section 5.4). Private-equity firms have been called "looters of own capital".[270] In Europe, however, company laws should set out to what extent and how the target may distribute funds to its owners. The Second Company Law Directive restricts

[269] In Germany, Franz Müntefering, a leading member of the Social Democratic Party (SPD), described private-equity firms as "swarms of locusts that fall on companies, stripping them bare before moving on." Private-equity firms have since been called Heuschrecken (locusts) in Germany.

[270] See, for example, Mahler A, "Systematisch geschwächt", Der Spiegel 38/2006 pp 100–101, interviewing professor Uwe H. Schneider.

the distributions to shareholders in public limited-liability companies (such as plc, AG, SA and SE). In addition, a high gearing and the risk of insolvency are likely to limit the amount of distributable funds according to the national provisions of Member States' company laws.

One of the most important ways to address legal concerns is to ensure that the target has only one shareholder (a squeeze-out right may be used) and, if the target was a listed company, to take it private (delisting). The target's shares will usually be owned by a limited partnership (after the merger of the special purpose company that was the buyer and the target). As there are no external minority shareholders claiming equivalent treatment or the furtherance of the long-term interests of the firm, it is easier to decide on distributions to the limited partnership, and it is easier for the limited partnership to make payments to its own owners (private equity investors).

From the perspective of the private-equity firm, there is an agency problem between the private-equity firm (the principal) and the target's board (the agent). Because of the thin line between making extreme distributions to owners (which is legal) on one hand, and making payments that lead to the company's insolvency (which is prohibited and may lead to civil remedies, criminal sanctions, or both) on the other, the role of the target's board is crucial.

The private-equity firm could address this agency problem by ensuring that the board consists of its own people. However, this might expose them to liability in the event that the board does not comply with its legal obligations.

Alternatively, the private-equity firm could mitigate: the liability risk by appointing executive members and "independent" members; and the agency problem by giving those executives a substantial block of shares in the target and remunerating outside board members well.

As a result, the limited partnership is thus the sole shareholder, unless the top managers of the target company have been given a block of shares in order to align their interests with those of the private-equity firm and make them friendlier.

In particular: financial assistance by the company. The Second Company Law Directive prohibits the provision of financial assistance to those who might want to acquire the company's shares. A company "may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party" (for exceptions, see section 20.4).[271]

The wording of the Directive is so broad that it could ban some leveraged buy-outs because the assets of the acquired company would, in fact, be the security for the acquisition. Interestingly, the original rationale for the prohibition of financial assistance in England was the prevention of "asset-stripping" takeovers or leveraged buy-outs.[272]

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[271] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive).

[272] See Armour J, Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law, Modern L R 63 (2000) p 368; Enriques L, Macey JR, Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules, Cornell L R 86 (2001) p 1181.

In practice, however, this rule has not hindered takeovers by private-equity firms. This is because the subsequent merger of the target with the special purpose company that is the buyer is not regarded as a prohibited form of financial assistance (section 20.4).

Trade sale or IPO? If the distributable assets of the target have already been distributed to owners, the private-equity firm is less dependent on the outcome of the sale for profits. However, the private-equity firm will want to increase profits and get a good price for the target's shares. It is important to decide how to sell the shares. The usual alternatives include an IPO and a trade sale. Shares can also be sold to another private-equity firm, or there can be a share exchange or merger.

If the takeover was very large, an IPO will in practice be the only exit form. First, a large competitor might be unable to buy the target because of competition laws (Chapter 14). Second, another private-equity firm would not be able to refinance the transaction because the target will be loaded with debt and have a very lean balance sheet. For this reason, there might not be a market for very large privately-owned companies.[273]

10.6 Walking Away

Investors do not always make a profit. In seed finance, most exits take the form of complete write-offs. It is part of normal banking practice to write off bad debts. Many trade debts must be written off as a credit loss. Walking away is therefore one of the most common forms of exit (see section 8.2).

IFRS. One of the oldest accounting principles in most jurisdictions is that assets must not be carried at more than the amount that the entity expects to recover from their use or sale. This impairment principle is included in every IFRS that deals with assets.[274]

Insolvency laws and liability. Where the investor is a controlling shareholder of a company, it may be more difficult for it just to write off the investment and walk away. First, the investor may have given personal guarantees for the debts of the company and can therefore be made personally liable according to their terms. Second, insolvency laws, the existence of fiduciary duties, or the doctrines of "lifting the veil" or "Durchgriff" may sometimes make a controlling shareholder personally liable to the company or its creditors where the investor can be said to have abused the company's assets or caused the company's insolvency. In some cases, the parent can be made responsible for subsidiary corporations.[275] Third, the investor or its board members or managers may also have participated in the gov-

[273] See, for example, Große Beteiligungsfonds in der Ausstiegsfalle, FAZ, 25 July 2006 p 17.

[274] See Cairns D, The Use of Fair Value in IFRS, Accounting in Europe 3(1) 2006 pp 5–22.

[275] Generally, see Hofstetter K, Parent Responsibility for Subsidiary Corporations: Evaluating European Trends, ICLQ 39 (1990) pp 576–598. In the US, the Bank Holding Company Act lays down a "source of strength" obligation that can require a holding company to inject capital into ailing bank subsidiaries.

ernance of the company in the capacity of members of the board who owe a personal duty of care to that company.

10.7 Liquidation

Liquidation or winding-up is the ultimate way to distribute a company's assets to its creditors and shareholders. It will be applied rarely, as it will result in the dissolution of the company.

Liquidation or winding-up is based on the provisions of Member States' national company and insolvency laws. In the absence of a general Liquidation Directive,[276] the approximation of Member States' liquidation or winding-up rules will in practice be limited to legal entities based on Community law. The SE is such a legal entity, but the SE Regulation contains few substantive provisions on liquidation or winding-up.

The SE Regulation refers to the law governing the SE: "As regards winding up, liquidation, insolvency, cessation of payments and similar procedures, an SE shall be governed by the legal provisions which would apply to a public limited-liability company formed in accordance with the law of the Member State in which its registered office is situated, including provisions relating to decision-making by the general meeting."[277]

[276] There is a draft Liquidation Directive from 1987. See Werlauff E, EU Company Law. Second Edition. DJØF Publishing, Copenhagen (2003) pp 615–630.

[277] Article 63 of Regulation 2157/2001 (SE Regulation).

11 Takeovers: Introduction

11.1 General Remarks, Parties

Business acquisitions can raise questions of the existence of the target firm. For the acquiring firm, business acquisitions are among the largest investments that it will make. Takeovers are one of the available corporate growth strategies and they tend to be popular in periods of general economic expansions.[1] Scale-increasing technological change is an important driver of takeover activity.[2]

Business acquisitions raise virtually all legal questions discussed earlier in this three-volume book. They are legally complicated. For example, the choice of parties, the legal structure of the transaction, the acquisition process, and acquisition funding are interrelated.

The purpose of this *introductory* chapter is to illustrate the high level of *variation* regarding the fundamental aspects of business acquisitions (the parties, acquisition structures, forms of consideration, acquisition funding, acquisition processes, and acquisition contracts) and the high level of interrelation between many fundamental questions.

About the terminology. The terms "takeover" and "acquisition" are used here generically and interchangeably for any acquisition of corporate control or business takeover. The terms "acquirer" (or "buyer") and "vendor" (or "seller") are used generically for the two core parties of the acquisition. The vendor may thus mean the shareholders that sell shares in the target company in a share deal, or the target company that sells a division in an asset deal, or a company that will be merged with another company.

Parties. One of the most important things influencing the legal framework of the acquisition is the identity of the parties.

Potential buyers can range from private persons to privately-owned firms and publicly-owned companies. Where the shares of a participating company are or will be admitted to trading on a regulated market in the EU, an extensive disclosure and information management regime will apply.

The vendor can be a company selling assets as part of its normal business, a company looking for synergy effects and economics of scale, a company about to

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[1] See Betton S, Eckbo BE, Thorburn KS, Corporate Takeovers. In: Eckbo BE (ed), Handbook of Corporate Finance: Empirical Corporate Finance, Volume 2. North-Hollande/Elsevier, Handbooks in Finance Series (2008), Chapter 15.

[2] Coase R, The Nature of the Firm, Economica, New Series, Vol 4, No 16 (1937) pp 386–405. See Betton S, Eckbo BE, Thorburn KS, *op cit*, Chapter 15.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
DOI 10.1007/ 978-3-642-03058-1_11, © Springer-Verlag Berlin Heidelberg 2010

collapse, a company that has filed for bankruptcy, or a company that sells assets as part of a confirmed Chapter 11-type reorganisation plan.[3]

For some firms, buying and selling companies is the main activity. A private-equity firm, a venture capital fund, or an LBO fund would act according to its own business model when acquiring a company.

Deutsche Bundesbank has defined private-equity firms, venture capital funds and LBO funds as follows:[4] "Private equity denotes, in the narrower sense, equity raised by an enterprise privately, ie not on a stock exchange. This is done by a financial investor – also known as a private-equity firm – collecting capital from wealthy individuals[5] and institutional investors and using it to purchase equity shares in firms. A venture capital fund is created when a financial investor provides funds for target companies that are either newly established or are refining products which are not yet ready for the market. An LBO fund, by contrast, uses these funds for leveraged buyouts, ie usually for purchasing an established company outright using a large proportion of debt."

11.2 Structures

The structure of the acquisition is influenced by: funding; company and securities law considerations common to all mergers and acquisitions; tax and accounting issues; general regulatory concerns (such as competition law concerns); industry-specific regulatory concerns (such as banking law concerns);[6] and other factors. Cross-border transactions are legally more complicated than domestic ones.

A typical acquisition can be structured as: the acquisition of shares (a share sale, share deal); the acquisition of assets (an assets sale, asset deal); the subscription of shares issued by the target; or a merger. Sometimes the sale is a sale by auction.

Although different legal structures could in principle be used to transfer control over the same business, those legal structures are not identical in the general economic sense, because the identity of the parties, the allocation of rights and obligations between the parties, the allocation of risks, the consideration, and many other things depend on the legal structure of the deal.

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[3] For an introduction to acquisitions of insolvent companies or their assets, see van Betteray W, Gass W, Vorverträge, Asset Deals und Unternehmenskaufverträge in der Insolvenz, BB 2004 pp 2309–2318; Gassner UM, Braun M, Die Failing Company Defense in der deutschen, europäischen und US-amerikanischen Fusionskontrolle, RIW 2004 pp 891–898.

[4] Deutsche Bundesbank, Leveraged buyouts: the role of financial intermediaries and aspects of financial stability. In: Monthly Report, April 2007 p 16.

[5] There are also listed funds which provide a wider range of investors with the opportunity to invest directly in private equity.

[6] Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice. New York City (2008) pp 129–130.

Core differences between different structures. Let us assume that a company A has five unincorporated divisions.[7] Company B can obtain one of those divisions in alternative ways:

- Because the division is unincorporated, an asset sale is possible.
- However, the transaction can also be structured as a share sale. Company A can incorporate, for example, NewCo and transfer the assets of the division to NewCo in return for NewCo's shares. Company A can then sell those shares to company B.
- In both cases, the consideration can alternatively consist of shares issued by company B. If the division is unincorporated, company A can subscribe for new shares in company B in exchange for assets. If company A has incorporated its division as NewCo, a share exchange can be used instead of a share sale. Company A will then subscribe for new shares in company B in exchange for shares of NewCo.
- If company A has incorporated its division as NewCo, company A and company B can alternatively agree on a merger. When NewCo is merged with company B, company A will receive shares of company B or other assets or a mix of securities and other assets as merger consideration.
- Even a division is possible. Company A can be divided into two new entities: RemainingCo that consists of the four remaining divisions, and the division to be separated from the rest. Company B can issue new shares as division consideration to the shareholders of company A.
- Company B can also buy company A's shares from company A's shareholders, divest the four divisions, and keep the division in which it has an interest.
- Instead of a sale, company B can propose a share exchange to company A's shareholders.
- Company B can also propose the merger of company A and company B.

Each alternative has its legal advantages and disadvantages, and there are fundamental differences between the alternatives[8] ranging from conglomerate discount to tax. The following is a short summary of some of the most fundamental differences.

Unlocking of conglomerate discount. Conglomerate discount can be a reason for the acquirer to prefer a share deal or a merger rather than an asset deal.

- The acquisition of control over a conglomerate company can help the acquirer to unlock conglomerate discount when the assets of the company are divested.

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[7] This example is from Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 160–161.

[8] The list is a modified version of the list in Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 160–161.

- When the acquirer purchases particular assets of a company rather than its shares, the acquirer typically cannot benefit from the unlocking of conglomerate discount.

Shareholder voting. The need to obtain shareholder approval will make the transaction more time-consuming. Such transactions also tend to be legally more complicated.

- A merger requires approval by both companies' boards and by both companies' general meetings. A merger does not require the consent of each individual shareholder. A (qualified) majority vote will suffice, and a merger is possible even where a minority of shareholders vote against it.
- An asset sale is typically decided on by both companies' boards. The acquirer's shareholders generally do not vote on the transaction in a share sale or an asset sale. However, where at least part of the consideration consists of new shares issued by the acquirer, the acquirer's general meeting decides on the issuing of shares and the waiving of existing shareholders' pre-emption rights, unless the general meeting has authorised the board to decide thereon. Furthermore, depending on the jurisdiction, the company's articles of association, and the applicable securities markets rules, large asset transactions may require the consent of the general meeting.
- Each of the target's shareholders will decide whether to sell or hold on to his shares in a share purchase. The same applies to a share exchange.

Appraisal rights and other rights of dissenting shareholders. A transaction that requires the consent of shareholders in general meeting is more likely to be constrained by mandatory provisions on the rights of dissenting shareholders. The availability of dissenting shareholders' remedies can make the transaction more time-consuming and increase legal risk.

Mergers and divisions are constrained by appraisal rights. Appraisal rights can make the acquisition more expensive.

Fair value provisions. In addition to appraisal rights, the valuation of shares and assets can be constained by other requirements as to fair value. Such requirements will typically apply in two situations.

- Share exchanges, the issuing of shares as a consideration for other assets, mergers, and divisions are constrained by mandatory provisions of law protecting shareholders of the issuing company (the company that acquires the other company). In mergers and divisions, they also protect shareholders of the target company.
- The target company's shareholders are also protected by sell-out rights and the regulation of squeeze-out rights. In companies whose shares have been admitted to trading on a regulated market, the target's shareholders are protected by provisions on mandatory bids.

Ease of transferring control. The role of shareholders is a key to how easy or difficult it is to obtain control over the target.

- Mergers are legally clear ways of transferring control because control is then transferred by operation of law. On the other hand, the procedure is time-consuming because of the statutory protection of shareholders and third parties.
- A share sale is less time-consuming, because the target company remains in existence and there are fewer rules protecting shareholders and third parties. Furthermore, control can be obtained without buying all shares of the target. This can reduce costs. However, it may be more difficult to obtain full control of the target. All shareholders may not be willing to sell their shares, and minority shareholders can use the remedies available to them in order to block decisions. Squeeze-out rights will not be available unless the holdings of the acquirer exceed a certain threshold.
- An asset sale is less time-consuming than a merger. In this case, the target's shareholders will not be a contract party. However, the acquirer cannot just buy majority control over a company's assets. This can increase costs compared with the purchase of a controlling block of shares.

Ease of passing consideration. The target's shareholders may prefer structures that give them direct access to consideration.

- In a merger or share sale, the consideration passes directly to the target's shareholders. The target's shareholders can thus prefer this option.
- In an asset sale, however, they are neither party to the contract nor entitled to consideration. This means that the target's board obtains more discretion. The seller can, for example, invest the consideration in other business ventures. Generally, the process of distributing the consideration to the seller's shareholders becomes more complicated in this case. For example, the seller can distribute the consideration as a dividend to its shareholders or be liquidated.

Ease of transferring assets. The acquirer may prefer structures that give easy access to the target company's assets.

- In a merger, title to all assets owned by each constituent corporation is automatically vested in the surviving corporation.
- In a share sale, title to the shares of the target company is transferred to the acquirer. It is easy to identify what is being bought and sold. However, the assets will still belong to the target company.
- In an asset sale, it is necessary to identify each and every asset being bought and sold, and to prepare documents of transfer with respect to each and every of them.
- Anti-assignment clauses and change of control clauses influence different structures in different ways.

Successor liability. Limitations on successor liability belong to reasons why acquirers can prefer asset deals.

- In an asset sale, the contractual obligations of the seller to third parties will not normally be transferred to the acquirer unless the acquirer and the seller have agreed otherwise. The transfer may require the consent of each third party to whom the obligations are owed.
- In a share sale, however, the target company will continue to be responsible for its own obligations, and the acquirer will bear a commercial risk in the capacity of its shareholder.
- In a merger, the surviving company succeeds to all liabilities of each constituent corporation.

Vendor liability. Most mergers and acquisitions are commercial failures. Whereas limitations on the liability of the vendor can make sellers prefer mergers or asset deals, the absence of such limitations can make acquirers prefer share deals.

- In a merger, shareholders of the company that will not survive the merger are not party to the contract between the participating companies and cannot be made liable for misstatements made on behalf of the company.
- In an asset deal, shareholders of the vendor company are protected by limited liability for the obligations of the company.
- In a share deal, shareholders of the target company are party to the acquisition agreement and potentially liable for misstatements made on their behalf.

Tax considerations and accounting issues. Tax considerations play a role when the parties compare structural alternatives. For example, many acquisitions are structured as tax-free share exchanges as a result of an acquirer's need to save cash and the desire of shareholders not to increase their taxable income. Questions of tax fall outside the scope of this book.

Even accounting issues fall outside the scope of this book. Typical accounting questions relate to the possible establishment of a new basis of accounting as a result of a change of control, and the accounting treatment of goodwill.[9] Typically, acquisition accounting is done either by the purchase or pooling of interests methods.

The purchase method is also called the acquisition method. According to IFRS 3, a business combination must be accounted for by applying the acquisition method, unless it is a combination involving entities or businesses under common control. Because of differences between the US GAAP and IFRS 3, the FASB and the IASB issued similar revised standards in 2008. Although the revised standards are largely based on IFRS 3, some differences remain.

[9] Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice.New York City (2008) pp 126–129.

Triangular transactions. One of the usual ways to combine the advantages of different structures is through the choice of a triangular structure.[10] It is characteristic of a triangular merger that the acquiring company sets up a shell subsidiary.

When the acquisition is structured as the purchase of shares for a cash consideration, the shell is capitalised with the consideration to be paid to the target company's shareholders. The target company's shareholders are bought out for cash. After the purchase of the target's shares, the shell is merged with the target company. As a result, the target firm ends up as a wholly-owned subsidiary of the acquirer.

Alternatively, the target company can subscribe for shares issued by the shell company in exchange for the transfer of the target's assets to the shell company, or the target company's shareholders can subscribe for shares issued by the shell company in exchange for shares of the target company. In both cases, the shell company will get new shareholders.

Financial investors typically use a shell acquisition vehicle, because it will enable them to avoid any direct recourse against their funds and to facilitate the financing structure.[11] Triangular structures are typically used in takeovers by private-equity firms (section 10.5). A triangular structure can also help to simplify the acquirer's own corporate decision-making.

Triangular structures are not used when the acquiring company pays for the acquisition by issuing its own shares in exchange for shares or assets.

Mergers of equals. "Mergers of equals" are governed by the same provisions of EU company law as mergers in general (section 5.11.4) but differ from custommary acquisitions in takeover practice.[12]

In a customary acquisition, the vendor or vendors expect the acquirer to pay a control premium. If control is shared between the parties, neither party can expect a control premium. In a merger of equals, the exchange ratio is typically set to reflect the relative asset, earnings, and capital contributions of the participating companies as well well as their market capitalisations if their shares have been admitted to trading on a regulated market.

A merger of equals structure can bring many benefits to the firm. (a) Such transactions are less costly than high premium acquisitions. They are therefore an alternative for smaller companies that would not otherwise have the financial capability to launch a large-scale expansion programme, and they have been usual in banking. For example, Citigroup grew by a series of acquisitions - in particular, the $140 billion merger of Citicorp and Travelers in 1998. (b) In industries with few acquisition targets, mergers of equals often represent the only effective avenue available to would-be acquirers for a large scale expansion. (c) In addition, mergers of equals can be an alternative where the shareholders of both companies

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[10] Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 161–162.

[11] Goldberg L, Acquisition Agreements from a Business Perspective (Principal Focus: Private Company Acquisition for Cash). In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice, Corporate Law and Practice Course Handbook Series. New York City (2008) pp 213–214.

[12] For US law, see Cole J Jr, Kirman I, *op cit*, pp 147–158.

enjoy private benefits which they want to keep after the merger. For example, the controlling shareholders of each company may agree to share control after the merger.

For legal reasons, it can be easier for the board to accept a merger of equals instead of a takeover offer made by an acquirer. The board has a legal duty to act in the interests of the company meaning that the board should try to ensure the long-term survival of the business organisation of the firm (Volume I). Whereas a takeover of the firm means that the board of the company and the firm's old management will not be able to influence its future business, a merger of equals can enable them to maintain some control and to protect the firm's survival chances in the future. It can therefore be easier for the target's board to explain the benefits of a merger of equals.

The absence of a control premium means that the structure of the combined companies will be important when the boards try to obtain shareholder approval. Shareholders of the company perceived as the weaker party are likely to be critical about the proposed transaction. (a) The post-merger corporate governance structure of the participating companies is a common way to signal to shareholders whether the transaction is a true merger of equals – or a normal acquisition for which the shareholders of the weaker company should receive a control premium. The negotiations can be difficult because the transaction is negotiated by people who have a vested interest in the outcome (the board members and managers of the participating companies). (b) Fairness opinions are important for both parties.

11.3 Consideration and Funding

The acquisition structure, the financing structure, and the choice of consideration are interrelated.

From the perspective of the acquirer, the consideration is an investment that must be funded. The terms of the acquisition agreement must therefore depend on the financing structure, and vice versa. Both depend on the preferences of investors providing the funding. For example, the acquisition structure and the positions taken by creditors in the financing structure determine the risk exposure of creditors.

Consideration. There can be different forms of consideration: cash, shares, other assets, or a combination. The price can be fixed or variable, and the price can be payable at different points in time. For example, the contract can contain terms on earn-outs, retentions, and completion accounts.

Funding. The acquisition can also be funded in various ways: by debt (LBO), target's assets (private equity), shares issued to the target's shareholders (share exchange offers, formal mergers), or other share issuings.

The target can be an important source of funding. In a share deal, mandatory provisions of company law typically restrict the giving of financial assistance to the buyer or subscriber of shares. However, company laws permit some forms of

distributions, and provisions of financial assistance can be circumvented by merging the target with the acquirer.

Interests. The acquirer and the vendor can have differing interests. The vendor often prefers a cash consideration. In that case, the acquirer must typically raise debt funding. The acquirer often prefers to pay by issuing new shares to the seller. The availability of cheap debt or financial assistance by the target or the fear of diluting its existing shareholder structure can nevertheless mean that the acquirer prefers a cash consideration.

11.4 Process

The acquisition process depends on the parties, the structure of the deal, and other circumstances. It can depend on:

- the party initiating the transaction (the acquirer can make a friendly bid or a hostile bid; the seller may choose whom to approach and whether to use an auction sale);
- the assets to be acquired (in an asset deal a company sells assets and is the contract party; in a share deal a shareholder sells his shares and is a contract party; in a merger the target company is a contract party but the merger consideration is paid to the target's shareholders);
- consensus (the prospective acquirer's bid can be friendly or hostile; an asset deal and a merger are friendly);
- source of funding (the acquirers's liquid assets, shares issued by the acquirer, financial institutions, the target's assets, or the capital market);
- the parties (their enterprise form plays a role; a listed company's actions are constrained by securities markets laws; a privately-owned company has more flexibility);
- the business (takeovers of regulated businesses can be subject to constraints and require permits; takeovers of unregulated business are more flexible);
- the country (apart from the usual questions of governing law, some countries restrict inward or outward capital movements or foreign ownership);
- the size and market share of the parties (competition laws are more likely to apply to takeovers where the parties are large in terms of market share or turnover); and
- tax laws.

Mitigation of the risk of opportunistic behaviour. There is a typical order of events and documents for each structure. Regardless of the structure, the management of information (Chapters 12–13) and the mitigation of the risk that the contract either will become binding too early or will not become binding (section 12.5 and Volume II) will play an important role and will be supported by preliminary agreements (heads of terms, confidentiality and exclusivity).

The parties typically try to mitigate the risk of opportunistic behaviour. Before negotiations start, the parties normally sign agreements covering confidentiality, standstill, and non-solicitation. The terms of such agreement are complemented by sanctions for breach of contract (for fiduciary outs, breakup fees and liquidated damages, see section 12.4.3).

The confidentiality agreement enables the target's board to open its books to the potential acquirer. Where the securities of a party have been admitted to trading on a regulated market, the confidentiality agreement can also allow the parties to negotiate without the listed company having to publicly disclose the proceedings (section 19.7).

In a share deal, the standstill agreement commits the potential acquirer not to purchase target shares in the market during negotiations. A standstill is particularly useful where the target is a listed company.

Non-solicitation ensures that neither the potential acquirer nor the target tries to hire key employees away from the other firm. It is also common for the potential acquirer to obtain tender agreements from target insiders, under which these insiders forsake the right to tender to a rival bidder.[13]

A due diligence will be necessary, and the parties normally agree on many forms of disclosure (Chapter 13). Generally, the purpose of due diligence is to reduce risk by increasing the availability and usefulness of information, and to increase price. Due diligence can vary according to the nature of the transaction and nature of the business.

Part of the acquirer's due diligence is to verify disclosures made by the seller. There is a link between the seller's disclosures and the seller's representations and warranties. Many disclosures will be made in a disclosure letter (section 13.2). Where one of the parties has issued shares admitted to trading on a regulated market, public disclosures will be governed by a mandatory disclosure regime complemented by civil, administrative and criminal sanctions.[14]

Auction sales. The process will also depend on the choice between an auction sale and a sale by private treaty. There is a typical order of events and documents for auction sales. For example, an auction sale typically requires a process letter that describes the order of events and the terms of the auction, an information memorandum that contains basic information that can be disclosed to potential bidders, and a data room where a number of serious bidders can verify the contents of the information memorandum. Compared with sales by private treaty, information management will be particularly challenging in auction sales because of the larger number of parties to whom information will be disclosed. The distribution of an information memorandum will also raise questions of potential liability misstatements.

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[13] See Betton S, Eckbo BE, Thorburn KS, *op cit*, Chapter 15.

[14] See, for example, section 397 of the Financial Services and Markets Act 2000.

11.5 Contents of the Sales Contract

The structure of the deal also influences the contents of the actual sales contract. The parties often separate signing and closing. When the deal is completed, the seller and the acquirer are expected to produce certain documents. The contract typically contains representations and warranties as well as indemnities in the event of breach of contract. The seller and the acquirer have differing approaches to warranties, and warranties also depend on whether there are multiple sellers or multiple buyers. The parties may agree on different forms of consideration, and there can be different funding options. Key provisions will also regulate the effect of the acquisition on employees, and tax issues.

Special remarks: venture capital. The contractual framework depends on the nature of the acquisition. For example, the following contracts can be necessary in a venture capital investment where an external investor becomes an active shareholder in the target company and the target company is managed by an entrepreneur who has so far been the sole shareholder of the company:[15]

Table 11.1 Contracts in a Venture Capital Transaction

Contract	*Parties*	*Explanation*
Non-disclosure agreement.	VC firm, target company.	The target company typically would not disclose confidential information without one.
Term sheet, letter of intent, or a preliminary agreement.	VC firm, entrepreneur, target company.	The VC firm's serious interest in making the contract makes it easier for the target to disclose more information and confidential information.
Master agreement.	VC firm, entrepreneur, target company.	Contains the big picture and basic terms of the whole transaction, complemented by detailed contract documents.
Contract for the purchase of shares by the VC firm.	VC firm, entrepreneur.	Enables the entrepreneur to cash out.
Contract for the subscription of shares by the VC firm.	VC firm, target company.	Enables the target to raise funding.
Credit agreement, agreement on convertible bonds or subordinated debt.	VC firm, target company.	Enable the VC firm to mitigate risk and manage agency relationships.
Credit agreement.	VC firm, entrepreneur.	The entrepreneur has a further incentive to act efficiently if the entrepreneur has borrowed money to subscribe for new shares in the company.

[15] For an introduction to the contractual framework, see Groner R, Private Equity – Recht. Stämpfli Verlag AG, Bern (2007) pp 24–35 and 120.

Credit agreement.	VC firm, entrepreneur.	The entrepreneur has a further incentive to act efficiently if the entrepreneur has borrowed money to subscribe for new shares in the company.
Contract for the subscription of shares by the entrepreneur.	Entrepreneur, target company.	
Employment contract.	Entrepreneur, target company.	Enables the VC firm to mitigate risk where the target company's business is dependent on the personal input of the entrepreneur. Sanctions for breach should be set out in the master agreement because of several legal constraints.
Contract for the purchase of advisory and administrative services.	VC firm, target company.	Enables the VC firm to make a profit selling services and to monitor the investment.
Schedules, Annexes.	Parties to each contract.	Contain technical information. This makes it easier to draft the documentation.

Harmonisation of contract law. Because of the nature of acquisitions and the large variety of contracts used by the parties, the legal background rules applicable to acquisition contracts can only be harmonised to a very limited extent. The first step would be to harmonise the regulation of contracts for the sale of shares or assets.

According to its wording, the CISG does not apply to share deals.[16] Neither is it designed to be applied to asset deals, as the target's assets cannot be regarded as typical movable goods. However, the regulation of sale of goods has been used as a model for the regulation of other contract types. For this reason, business acquisition contracts have not been excluded from the scope of the part of the DCFR that applies to contracts for the sale of goods. The sale of goods provisions of the DCFR apply to such contracts "with appropriate adaptations".[17]

In the Member States, business acquisition contracts can be covered by the provisions applicable to sale of goods or the sale of rights (see Chapter 16) For historical reasons, the differences between the contract laws of different Member States can be relatively small (see Volume II). This means that the provisions of the CISG and the sale of goods provisions of the DCFR can often be used as a "shortcut" (see also Volume II).

[16] CISG Article 2(d).
[17] DCFR IV.A.–1:101(2).

11.6 Summary

Business acquisitions can take various forms: The acquirer can buy shares in the target company (share deal) or assets (asset deal). The acquirer can also subscribe for new shares issued by the target, or the takeover can be a formal merger. There can two parties or multiple parties. The target company can be listed or unlisted. If it is a listed company, the acquirer can either make a public bid for its shares or buy them privately. If the acquirer is a private-equity firm, the takeover will normally be executed in one way, but if the acquirer is an industrial firm, it might be executed in another way. The acquisition can be funded in various ways. If the parties are major companies, takeovers can be constrained by competition laws.

About the following chapters. The most simple acquisition form is the acquisition of a private company by one private acquirer for cash. This acquisition form will therefore be discussed next. The acquisition of assets, the acquisition of a company by way of merger, and the particular aspects of the acquisition of a company whose shares have been admitted to trading on a regulated market will be discussed in later parts of this book. Other questions that will be discussed include the duties of the board in takeovers, takeover defences, competition law aspects, and acquisition finance.

12 Acquisition of Shares in a Privately-owned Company for Cash

12.1 Introduction

The basic acquisition form is the acquisition of shares in a privately-owned company by one private acquirer for cash. In this chapter, some preliminary questions relating to the acquisition process will be studied mainly in that context.

Parties. The choice of the parties depends on the structure of the acquisition. In an asset deal, the vendor is the owner of the business sold to the buyer. In a share deal, only shares are sold, meaning that the actual business of the target company is not owned by the vendor.

The fact that the target company is not party to the contract in a share deal can give rise to certain legal problems. (a) The actual vendor may not have unlimited access to information about the target company. Shareholders generally do not have unlimited access to information about the company in their capacity as shareholders. (b) The organs of the target company do not have a duty to permit unlimited access to information about the company to existing shareholders or potential future shareholders. (c) Whether the organs of the target company can permit the disclosure of information depends on their general company law duties. For example, members of the board of directors owe duties of care and fiduciary duties to the company, and their actions are constrained by the principle of equivalent treatment of shareholders in the same position. This also means that the target company's board, managing director, and other organs do not have a duty to always permit due diligence by the prospective buyer. (d) The party having unlimited access to information about the company – that is, the company itself – will typically not give warranties or indemnities to the buyer in a share deal.

Management of information. The acquisition process begins with information management. All financial decisions are based on information. The acquirer's perceived risk is increased and the vendor will receive a lower price, unless the acquirer is given access to information about the target and its business. However, there is a risk that the acquirer will abuse the target's business secrets. For this reason, the parties use confidentiality agreements. More information is disclosed to the prospective acquirer during the course of the acquisition process depending on how likely the closing of the contract is. Information will therefore be disclosed in phases that follow the signing of a non-disclosure agreement, the signing of a letter of intent, the signing of the acquisition agreement, and closing.

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The management of information belongs to the most important duties of the acquirer's board of directors deciding on the acquisition. Members of the board can benefit from the business judgment rule only provided that they make an informed decision in good faith.

In *Smith v. Van Gorkom*,[1] the Delaware Supreme Court decided that the board of directors of Trans Union Corporation, while acting in good faith, had nonetheless been grossly negligent in recommending a merger offer, in part, because the board had not made an "informed" decision. For the business judgment rule, see Volume I.

The *acquirer's* board members should therefore ensure that: there is reason for the acquirer to buy; the acquirer knows about the characteristics and quality of the target; the price is not too high; and the terms are acceptable.

In an asset deal, the *vendor's* board members should ensure that: there is reason for the vendor to sell; the vendor's confidential information is protected; the vendor obtains a high enough price; and the terms are acceptable.

In a share deal, the *target's* board members should ensure that: it is in the interests of the company to provide information to one or more of the parties; it is permitted to provide information; and the terms of disclosure are acceptable.

Management of when the contract becomes binding (signing and closing). The separation of signing and closing belongs to the most popular ways to ensure that: the target gives the prospective acquirer access to confidential information only after the acquirer has confirmed that it is prepared to close the deal on certain conditions; the prospective acquirer is entitled to verify the statements of the seller and the target before the contract becomes binding; the parties do not conclude a contract before it is clear that the commercial purpose of the contract can be achieved.

Management of counterparty corporate risk (representations). Counterparty corporate risk is typically mitigated in three main ways (Volume II). First, each party will deal with the other party through its "organs".[2] Second, contractual representations will deal with typical counterparty corporate risks. Third, a legal opinion will typically state that the contract is legal and enforceable according to its terms.

The specifications of the shares, the target company, and its business (warranties). In both share deals and asset deals, the caveat emptor principle typically applies. However, the interpretation of contracts is flexible (Volume II) and influenced by information exchanged by the parties or by various people on the behalf of each party (for information management generally, see Volume I; for contractual information duties, see Volume II). Both parties will therefore find it important to regulate the specifications of the target. In an asset deal, it is necessary to identify the assets in detail.

Management of counterparty commercial risk. Both parties want to ensure that the other will fulfil its obligations. The acquirer mitigates counterparty commercial risk through: due diligence and information in general (transparency); detailed

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1 Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

2 Article 9(1) of Directive 68/151/EEC (First Company Law Directive).

terms on the obligations of the vendor (rule-based strategy); a variable purchase price the amount of which depends on the degree of compliance with the specifications of the target (alignment of interests); and contractual sanctions in the event of breach of contract (alignment of interests).

Funding. The terms of the funding mix can influence many of the obligations of the vendor (section 20.5).

12.2 Confidentiality

During the course of negotiations, information is disclosed step by step depending on how likely it is that the parties will reach agreement on mutually acceptable terms and how likely it is that the prospective acquirer will not abuse the target's confidential information. The degree of confidentiality will thus influence the information disclosed to the prospective acquirer. The parties will try to ensure confidentiality by legal and technical means.

Non-disclosure agreement. In all companies, the people who decide on disclosure of information will have a duty of care based on the provisions of company law (board members, the managing director/CEO), contract law, or labour law (other senior managers, employees). Unnecessary or unrestricted disclosure of confidential information can cause the firm damage.

The purpose of a non-disclosure agreement (NDA) is to prohibit the prospective acquirer from abusing the target company's or seller's confidential information. The target company does not permit the acquirer's due diligence without an NDA.[3]

An NDA usually contains: a prohibition to disclose confidential information disclosed by the seller or the target other than to a certain group designated in the NDA; a prohition to use confidential information other than for the purpose of valuation of the target; a prohibition to disclose the existence of the NDA and the negotiations; a duty to ensure that the acquirer's advisers, board members, and other persons to whom information may be disclosed comply with the NDA; and a clause on liquidated damages payable in the event of breach.

Insider lists and access to inside information. If a party is a company whose securities have been admitted to trading on a regulated market, it must also limit access to inside information and draw up insider lists.

[3] The following is an example of what can happen in the worst case without and NDA. Burroughs B, Helyar J, Barbarians at the Gate. The Fall of RJR Nabisco (1990) : "... it was obvious that Dole had somehow gained access to a wealth of Del Monte confidential information: shipping schedules, production forecasts, everything. Del Monte's competitive position ... had been seriously compromised. ... Dole had been allowed to snoop into Del Monte's most secret files. ... Several weeks later [a Del Monte manager] received a Federal Express package apparently misrouted by a clerk at Dole headquarters. Inside he found photocopied sheets of Del Monte financial data. ... It was clear Dole was sending the data to its executives around the world. By then, of course, it was too late to do anything about it."

The Directive on market abuse provides for a duty to disclose inside information to the public.[4] There is nevertheless a right to delay disclosure, provided the public is not misled and the confidentiality of information is ensured.[5] Disclosure of inside information to any third party triggers a duty to make the same information public, unless confidentiality is ensured.[6] In other words, the issuer must use NDAs.

The Directive on market abuse and implementing legislation require permanent *company-specific* insider lists that are regularly updated. The persons required to draw up lists of insiders must take the necessary measures to ensure that any person on such a list that has access to inside information acknowledges the legal and regulatory duties entailed and is aware of the sanctions attaching to the misuse or improper circulation of such information.[7]

Stock exchange rules can require *project-specific* insider lists. Such lists will be drawn up before the commencement of takeover negotiations.

Data room. Data room is a place that contains documents (or computer files) that help the acquirer to verify the seller's representations and warranties. There is thus a link between the contents of warranties (section 16.2), due diligence (Chapter 13), and the contents of the data room. The data room helps the target to restrict access to confidential information not required for the purposes of the transaction.

12.3 Preliminary Understanding

The negotiations will give rise to direct costs. The parties must invest in the production and exchange of information, and pay fees for legal and other advice. There are indirect costs caused by the involvement of management in negotiations rather than in the actual running of the firm's business. The talks can leak out, upset a party's stakeholders, and increase the volatility of a party's share price. Furthermore, the negotiations can attract competing bidders and investors trying to make money from blocking the deal.

For these and many other reasons, the preliminary discussions as to price, structure, and other factors will often be concluded by the signing of a letter of intent or a similar preliminary contract.

A letter of intent is a way to manage information and risk. A letter of intent can become necessary because there comes a point during the negotiations (a) when it is not reasonable or safe for the seller or the target to disclose more information or invest in its production unless they can be relatively sure of the acquirer's serious intent to buy (rather than to merely gain access to business secrets) (b) but the acquirer does not yet want to be bound because the acquirer does not possess sufficient information about the target.

[4] Article 6(1) of Directive 2003/6/EC (Directive on market abuse).
[5] Article 6(2) of Directive 2003/6/EC (Directive on market abuse).
[6] Article 6(3) of Directive 2003/6/EC (Directive on market abuse).
[7] Article 5(5) of Directive 2004/72/EC.

The signing of a letter of intent typically ends the preliminary discussions as to the structure of the deal, the price or pricing method, the form of consideration, and other key terms. The negotiation process then shifts to the preparation of definitive contract documentation. At the same time, the acquirer will conduct due diligence, and the parties will prepare for taking the necessary corporate action and seeking the necessary regulatory approvals.[8]

A letter of intent creates a sense of *moral obligation* and provides a framework and context for further negotiations and due diligence.[9]

Whether it is legally binding and enforceable depends very much on its actual wording (not its heading). In practice, most letters of intent specifically state that they do not create a binding obligation. In the US, such a clause is called the *Texaco clause*.[10]

In 1984, Pennzoil, Co. intended to acquire Getty Oil Company. In January 1984, a "Memorandum of Agreement" was drafted between Pennzoil and various Getty entities to reflect the terms that had been reached in conversations between their representatives. However, the board of Getty Oil accepted an offer made by Texaco. Pennzoil demanded that the Getty entities honour their agreement with Pennzoil and sued Texaco for damages and punitive damages for Texaco's tortuous interference. Pennzoil's claim for damages and punitive damages prevailed. Before *Texaco, Inc. v. Pennzoil Co.*,[11] it was believed that such an agreement-in-principle was not a final, binding agreement, but rather, a commitment that the deal would proceed on the announced terms if residual issues were satisfactorily resolved. Since *Texaco, Inc. v. Pennzoil Co.*, it is standard practice to include a disclaimer of intent to be bound in every pre-closing document.

In the absence of such a clause, legal risk is increased for a party that does not yet want to be bound. If the letter of intent contains the necessary terms of the transaction, the probability that the court will regard the letter of intent as a binding sales contract will be increased. This may be the case when the only things missing are a due diligence examination, regulatory approvals, and other formalities (see section 12.5).

In the US case of *United Acquisitions Corp. v Banque Paribas*,[12] the court adopted a four-factor test for determining whether a letter of intent is binding: (1) Does the document contain an express statement of intent to be bound only by a written agreement? (2) Has one party partially performed and has the other party accepted that performance? (3) Are there issues remaining to be negotiated? (4) Does the agreement involve complex issues in which definitive written contracts are the norm?[13]

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[8] See Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 173–175.

[9] *Ibid*, pp 174–175.

[10] See Johnston JS, Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation, Virg L R 85 (1999) pp 459–460.

[11] Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. App. 1987).

[12] United Acquisitions Corp. v. Banque Paribas, 631 F.Supp. 797 (S.D.N.Y.1985).

[13] Bainbridge SM, *op cit*, pp 174–175.

A letter of intent can also exclude a party's possible right to claim reimbursement for damage for breach of pre-contractual duties in the event that the other party decides to end talks. Legal background rules may, depending on the governing law, provide for a duty to reimburse the other party for costs where a party is deemed not to have negotiated in good faith (Volume II).[14]

12.4 Ensuring Exclusivity, Deal Protection Devices

12.4.1 General Remarks

As stated above, a non-disclosure agreement and a letter of intent can protect *the target and the seller* by increasing the likelihood of the conclusion of the contract and mitigating the risk of abuse of the target's confidential information. On the other hand, *the prospective acquirer* wants protection as well, because the vendor or its board may want to see whether a third party can offer better terms.

Acquirer's costs. The prospective acquirer can incur substantial up-front costs in making the offer: search costs entailed in identifying an appropriate target; fees for legal, accounting, and financial advice; commitment and other financing fees; and the cost of neglecting alternative acquisition opportunities.[15]

The vendor can benefit from that investment in the production and exchange of information if it has an option to seek out competing bids at no cost. The emergence of a competing bid would reduce or eliminate the expected return on the prospective acquirer's sunk costs. In fact, second bidders often prevail.[16] Even where the party prevailing is the initial bidder, the ultimate acquisition price can be substantially higher than the initial bid because of increased competition.[17]

For this reason, the prospective buyer will try to ensure exclusivity through clauses discouraging competing bids, or through lock-ups.

Better terms and board duties. In contrast, the vendor, the target, or their boards may prefer an option to choose an acquirer that offers better terms, and a "market check".[18]

There are essentially two types of market checks. The first is a pre-agreement market check where, prior to signing an agreement, a company attempts to identify interested acquirers and the best terms without initiating a formal auction. A target company is bound to attract some interest if it becomes known that it is "in play".

The second type of market check is a post-agreement market check. As its name implies, a transaction is agreed to, subject to public announcement of the

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[14] See Article 2:103 of the Acquis Principles.

[15] Bainbridge SM, *op cit*, p 179.

[16] *Ibid*.

[17] See *ibid*, citing Bruback RS, Assessing Competition in the Market for Corporate Acquisition, J Fin Econ 11 (1983) pp 141 and 147.

[18] Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice. New York City (2008) pp 71–73.

transaction and a fair opportunity for other bidders to make competing offers. For legal reasons, post-agreement market checks are more common in the US than in Europe.[19]

In 2007, ABN AMRO, a large European bank that was later taken over by a consortium of banks, agreed to sell ABN AMRO North America Holding Company, which principally consisted of the retail and commercial banking activities of LaSalle Bank Corporation, to Bank of America for $21 billion in cash. ABN AMRO was desperate to use the sale as a takeover defence. The sales agreement nevertheless contained a "go-shop" clause. The clause allowed solicitation of interest for LaSalle within 14 days. Bank of America had a right to match a superior bid within five days. If it decided not to exercise its right, the agreement would expire and ABN AMRO would have to pay a break-up fee of $200 million to Bank of America.

12.4.2 Exclusivity Clauses

Exclusivity clauses can be divided into two basic categories: performance promises and cancellation fees.

The prospective acquirer would prefer performance obligations to be undertaken by all the parties that it in fact negotiates with and who can influence the fate of the negotiations: the seller; the target; the target's main shareholders; the target's board; and so forth (for legal constraints, see below).

Performance clauses. The main performance clauses include: no negotiation clauses; no-shop clauses; no contract clauses (no merger clauses); no talk clauses; and lock-ups.[20]

No negotiation clauses prohibit the seller from negotiating with competing bidders.

No-shop clauses prohibit the target from soliciting a competing offer from any other prospective acquirers. However, such a clause can allow the target to consider an unsolicited bid and even negotiate with the competing bidder.

No contract clauses (no merger clauses) permit the target to negotiate with a prospective competing acquirer, but prohibits it from entering into an agreement with the competitor until the initial bid has been brought before the shareholders. Such clauses are meaningful provided that the transaction is one that must be approved by the general meeting.

Performance promises are sometimes qualified by using best efforts clauses (for the dilution of clauses, see Volume II).

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[19] *Ibid*, p 73: "Although a market check has never been explicitly required by the Delaware courts, it can allow the market to validate a board's decision to accept a buyout proposal and help establish the board's fulfillment of its Revlon duties. Post-signing market checks can be particularly useful in the management buyout context, where pre-signing auctions are difficult (due to the advantages of the bidder who is allied with management, and the difficulties of allowing management to work with multiple bidders) and where allegations of conflicts of interest and Revlon violations are frequent."

[20] Bainbridge SM, *op cit*, pp 180–181.

Best efforts clauses. A best efforts clause requires both parties to use their "best efforts" to consummate the transaction. The purpose of a best efforts clause is to impose a minimum duty to act in good faith toward the party to whom the best efforts obligation is owed.[21]

Recommendation clauses. Where the transaction must be authorised by the vendor's shareholders, the prospective acquirer may wish to secure from the directors of the target company a legally binding undertaking to recommend the offer to the shareholders of the target and not to encourage or co-operate with any "white knight" (section 18.7) which may emerge as a rival.[22]

Cancellation fees, break-up fees. Cancellation fees (also known as break-up fees) are a common way to protect the prospective acquirer in particular where the transaction requires approval by the target's general meeting and/or board of directors, and the target has not yet taken necessary corporate action.

Cancellation fees are essentially liquidated damages payable if the acquirer fails to receive the expected benefits of the agreement. In effect, the target is required to pay a specified amount to the acquirer in the event that the transaction is not consummated, reimbursing the acquirer for out-of-pocket costs associated with making the offer and perhaps also including an increment reflecting the acquirer's lost time and opportunities.[23]

Engagement fees are a variation of the same theme. White knights proposing a leveraged buyout of the target in response to a hostile takeover bid frequently require an engagement fee, requiring the target to pay a relatively small fee as consideration for the white knight's preparation and submission of the bid.[24]

Lock-ups. Exclusivity clauses might not prevent competing offers, because exclusivity clauses are not binding on third parties and may not even be enforceable against the target company or its organs. The prospective buyer may therefore want to make exclusivity clauses more effective as a deterrent.

In this context, a lock-up is any arrangement or transaction by which the acquirer obtains a competitive advantage over other acquirers in order to deter third-party interest. So defined, the term includes such tactics as an unusually large cancellation fee or an agreement by the target to use takeover defenses to protect the favoured offer from competition. It can include both shareholder lock-ups and asset lock-ups.[25]

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[21] *Ibid*.

[22] See Davies PL, Gower and Davies' Principles of Modern Company Law, Seventh Edition. Sweet & Maxwell, London (2003) p 720: "Indeed, the initial bidder may not be willing to make a bid for the target unless such assurances are forthcoming. This situation has given rise to discussion of a second proposition, namely that directors may not effectively limit their discretion to act in whatever way seems to them at any given time to be in the best interests of the company, and so cannot give legally binding undertakings of the type sought by the initial bidder … It is true that the courts exhibit some reluctance to regard undertakings of this sort, given by the incumbent management, as intended by the parties to have contractual force."

[23] Bainbridge SM, *op cit*, pp 180–181. See also Cole J Jr, Kirman I, *op cit*, p 72.

[24] Bainbridge SM, *op cit*, pp 180–181.

[25] Cole J Jr, Kirman I, *op cit*, p 72; Bainbridge SM, *op cit*, pp 191–192.

Shareholder lock-ups. In shareholder lock-ups, the favoured acquirer enters into a lock-up arrangement with a large target shareholder or shareholder group. Shareholder lock-ups can include: share purchase agreements; options to purchase shares; agreements to sell only to the bidder; agreements not to sell to others; and voting agreements.

If the target company's shares have been admitted to trading on a regulated market, the use of such shareholder lock-ups typically triggers a duty to disclose major shareholdings under the Transparency Directive,[26] and may trigger a duty to make a mandatory offer under the Directive on takeover bids.[27]

Cash-settled derivatives. There is a difference between shareholder lock-ups and the use of cash-settled derivatives. For example, when Porsche AG (and later Porsche Automobil Holding SE) started to increase its stake in Volkswagen AG in preparation for the abolition or amendment of the so-called Volkswagen Law, Porsche used swap contracts to secure the transaction. The choice of derivatives rather than shareholder lock-ups was influenced by legal constraints (for creeping takeovers, see section 19.3).

Asset lock-ups: the Alma Media case. Asset lock-up options grant the favoured acquirer an option to purchase a significant target asset. Asset lock-ups are principally intended to end or prevent competitive bidding for the target. From the perspective of the target, the prospective acquirer's asset lock-up options work as the "crown jewel" takeover defence strategy.[28]

The use of asset lock-ups can be illustrated by the Alma Media case. In 2004, the Finnish media group Alma Media Corporation owned newspaper assets and broadcasting assets. In addition to a Finnish commercial television company (MTV3), it owned a quarter of the largest commercial television company in Sweden (TV4). Access to TV4 shares gave other shareholders of TV4 an incentive to acquire Alma Media. Whoever obtained control over Alma Media would end up with control over TV4 as well.

In December 2004, the Norwegian media group Schibsted ASA finally launched a public tender offer for Alma Media. In January 2005, Alma Media's board of directors took takeover defences by proposing an alternative to Schibsted's offer. The broadcasting division was to be sold to Bonnier and Proventus, two Swedish companies. After a complicated series of transactions, Alma Media's broadcasting assets were owned by a company owned by Bonnier and Proventus. Alma Media was an independent company that owned newspaper assets. Schibsted remained a small shareholder in Alma Media. (See also section 18.11 for the Dofasco case.)

Legal aspects of exclusivity clauses and lock-ups. Exclusivity clauses and lock-ups raise three kinds of particular legal questions in the target company. First, company law rules on board duties and the question to whom they are owed will act as a constraint. Second, it can be unclear to what extent company law rules on intra-company distribution of power can make contractual clauses invalid or unenforceable. Third, company law and securities markets law rules can influence the avail-

[26] Article 9(1) of Directive 2004/109/EC (Transparency Directive).
[27] Article 5(1) of Directive 2004/25/EC (Directive on takeover bids).
[28] Bainbridge SM, *op cit*, pp 191–192.

ability and enforceability of takeover defences. All these questions will be discussed in detail below.

12.4.3 Ensuring Exclusivity v Company Law

Second bidders often prevail in competitive bidding contests. Even if the initial bidder prevails, the ultimate acquisition price is likely to be substantially higher than the initial bid.[29] One of the key issues in the negotiated acquisition context is whether the target or the vendor is permitted or even obliged to seek out competing offers. This is usually addressed in the acquisition agreement or separate side agreements.[30]

Internal distribution of power and protecting the deal. The use of deal protection devices is constrained by the internal distribution of power in the company. While the agreement may have been negotiated by one corporate body, it may have to be authorised by another corporate body.

According to EU company law, the terms of mergers and cross-border mergers must be authorised by the general meeting (section 5.11.4). Depending on the governing law and the articles of association of the target or vendor, even other transactions may have to be authorised by the general meeting. The company may also have a two-tier board or two-tier board structures, and the transaction may require the consent of its supervisory board or another controlling body.

Community law. The question is, therefore, can the board accept deal protection mechanisms, if the transaction must be decided on by the general meeting according to provisions of Community law?[31]

Now, a transaction that under Community law must be decided on or authorised by the general meeting is a transaction which is legitimate in itself. It is a general technique used by the ECJ that ancillary restrictions which are objectively necessary to achieve legitimate objectives under Community law are permitted provided that they are proportionate to achieving their objectives.

As far as EU company law directives are concerned, it can therefore be assumed that deal protection devices might be compatible with Community law provided that they they are objectively necessary, proportionate, and do not have the effect of frustrating the powers of the general meeting.

Member States' laws. Similar problems can arise under Member States' national laws. For example, if a company has a statutory two-tier board structure, important transactions will typically be authorised by the controlling body (such as the supervisory board in a German AG) unless they have to be decided on by the general meeting.

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29 *Ibid*, p 179, citing Bruback RS, Assessing Competition in the Market for Corporate Acquisition, J Fin Econ 11 (1983) pp 141 and, 147. Bruback found that second bidders prevailed in 75% of the 48 cases examined.

30 Bainbridge SM, *op cit*, p 174.

31 The topic of this book is limited to Community law.

Board duties, "fiduciary out" under Delaware law. Particular board duties can influence the use of deal protection mechanisms especially where board members owe a duty to act in the interests of existing shareholders rather than the firm. For example, a merger agreement tends to require a fiduciary out clause under Delaware law.

In Delaware, deal protection devices used to be recognised as permissible means of protecting a deal from third-party interference in transactions not involving a sale of control. The *Unocal* standard was applied. There should therefore be reasonable grounds to believe that a third-party bid would be a danger to corporate policy, and the deal protection measure should be reasonable in response to the perceived threat.

In contrast, the *Revlon* test is applied to the use of deal protection devices in change-of-control transactions. The deal protection device must therefore be designed to secure the best value reasonably available to stockholders.[32]

The Delaware Supreme Court's 2003 opinion in *Omnicare*[33] signals a change in both the standard of review and substantive law applicable in Delaware. In Omnicare, the court adopted a per se rule invalidating board approval of "locked up" transactions and emphasised the duty of the board to obtain the best price. After Omnicare, contracts have required some form of fiduciary out.[34]

Under Delaware law, the legal effect of an exclusive merger agreement depends on target directors' fiduciary duties. There is an established "basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's shareholders".[35] Directors cannot validly contract away this duty, because a contract that purports to relieve directors of their fiduciary duties is not binding.[36] For this reason, a merger agreement tends to be subject to a "fiduciary out" clause: "A fiduciary out may simply be a proviso stating that nothing contained in the merger agreement shall relieve the board of directors of its fiduciary duty to the shareholders. Alternatively, the fiduciary out may expressly retain a right for the target's board to solicit other offers or to negotiate with other bidders if its fiduciary duties so require. The most potent version relieves the target board of its obligation to recommend the initial offer to the shareholders if a better offer is made or permits the target to terminate the merger agreement if a higher offer is received. Buyers typically resist inclusion of a fiduciary out, as it largely undermines the basic purpose of an exclusive merger agreement (especially in the latter variants), while there is a division of opinion among takeover practitioners as to whether targets should insist on such a provision."[37]

No "fiduciary out" requirement under Community law. A "fiduciary out" is not part of EU company law. The main rule is that where the acquirer has dealt with the vendor through an "organ" authorised to represent it under Article 9 of the First Company Law Directive, the agreement is enforceable against the vendor

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32 Cole J Jr, Kirman I, *op cit*, pp 86–87.

33 Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).

34 Cole J Jr, Kirman I, *op cit*, p 92. For deal protection devices under Delaware law in general, See, for example, Rieckers O, Treuepflichten versus Vertragsfreiheit. Neues zur Wirksamkeit von Deal-Protection-Klauseln in der Rechtsprechung Delawares, RIW 2003 pp 668–676.

35 Unocal Corp. v. Mesa petroleum Co., 493 A.2d 946, 955 (Del. 1985).

36 Bainbridge SM, *op cit*, p 182.

37 Bainbridge SM, *op cit*, pp 183–184.

and the vendor may not invoke problems with its internal decision-making against the acquirer (for counterparty corporate risk, see Volume II).

However, there can be clear statutory restrictions on the right of the acquirer's "organs" to represent it. Breach of those constraints can be invoked against the acquirer.[38]

Some of those constraints are based on provisions of EU company law that make certain transactions subject to authorisation by the general meeting. They apply in particular to mergers, cross-border mergers, the formation of an SE, and generally the issuing of shares (or rather, the increasing of some forms of "legal capital"). Where a transaction must be decided on by the general meeting under EU company law, the decision rights of the general meeting must not be frustrated by any agreement to the contrary.

Other constraints can be based on mandatory provisions of Member States' national laws setting out the "organ's" duties. For example, members of the board may not contract out of their duty of care owed to the company or their duty to act in the interests of the company. On the other hand, those duties are typically qualified by the business judgment rule or similar rules.

In principle, such restrictions can therefore influence the validity of some agreements that seek to ensure exclusivity.

Exclusivity clauses are nevertheless not prohibited as such. On the contrary, exclusivity clauses are often objectively necessary and in the interests of the vendor, because there might not be any acquisition agreement between the acquirer and the vendor if the vendor could freely solicit competing offers and eventually abuse work done by the acquirer and its often substantial up-front costs in making the offer. In many cases, exclusivity clauses can reduce risk for both parties, give an incentive to invest in information and the negotiation process in general, mitigate information asymmetries, and lead to a higher price.

This means that performance promises such as best efforts clauses and various forms of no-shop covenants tend to be unproblematic from the perspective of EU company law and Member States' national company laws.

On the other hand, provisions for monetary compensation in the event that the transaction fails to go forward can be legally more problematic.

Some provisions on monetary compensation can be necessary in order to: signal the intention to negotiate in good faith; facilitate mutual investment in information and the mutual disclosure of information; and mitigate the risk of abuse of confidential information.

However, sometimes the vendor's cancellation fees and liquidated damages are not intended to reimburse the acquirer for out-of-pocket costs associated with making the offer and perhaps its lost time and opportunities but to frustrate the right of the vendor's corporate bodies to decide on the transaction. Excessively high cancellation fees and liquidated damages can violate the mandatory duties of

[38] Article 9(1) of Directive 68/151/EEC (First Company Law Directive): "Acts done by the organs of the company shall be binding upon it even if those acts are not within the objects of the company, unless such acts exceed the powers that the law confers or allows to be conferred on those organs ..."

the "organ" through which the acquirer has acted, and fall outside of the "powers that the law confers or allows to be conferred" on that organ; if this is the case, Article 9 of the First Company Law Directive does not prevent the acquirer from invoking the restriction against the acquirer.

12.5 Signing, Conditions Precedent to Closing

The separation of "signing" and "closing" is an Anglo-American technique commonly applied in commercial contracts worldwide.

Problems with legal background rules. It is a traditional principle of law in continental Europe and the Nordic countries that the conclusion of the contract, the delivery of the object, the passing of risk, and payment of the purchase price happen more or less simultaneously. However, traditional contract law rules can cause problems in complicated transactions such as business acquisition contracts:

- Either the vendor or the target will not want to let the prospective acquirer inspect the object unless the parties are relatively likely to conclude a binding contract (there is always the risk that the prospective buyer walks away and uses the target's business secrets for business purposes).
- The prospective acquirer will not want to conclude the contract unless it can inspect the object first.
- The prospective acquirer will not want to conclude the contract unless it is sure that all necessary permits will be obtained and sufficient funds are available, and these questions can often be solved only after there is a contract.
- In addition, the vendor will not want to hand the object over to the acquirer unless the acquirer has paid the purchase price, and the acquirer does not want to pay the purchase price unless the object is handed over to the acquirer.

Separation of signing and closing. These problems can be solved when the signing of contract documents is separated from payment of the purchase price, delivery of the object, and the passing over of risk. The separation of signing and closing enables the parties to apply the traditional Zug-um-Zug principle (also known as the cash against delivery principle). The Zug-um-Zug principle means that the seller hands over the goods and the buyer pays the purchase price simultaneously. In practice, the parties agree on the following procedure:

- The contract documents will be *signed* when the parties have reached agreement.
- The transaction will not become final unless there is a *closing*.
- There will not be any closing unless *conditions precedent* to closing are fulfilled or the party protected by the conditions precedent gives his consent.

Typical conditions precedent to closing. Conditions precedent are used because it is always better to walk away from a terrible contract before it is too late than be sorry afterwards. The conditions precedent are fairly similar in different kinds of business acquisition contracts. Conditions precedent typically address things that can make the transaction commercially meaningless or unattractive to the acquirer:

- The absence of material adverse change (MAC) is a catch-all provision that also deals with the risk that the target has changed between signing and closing. The definition of MAC is typically heavily negotiated (see below).[39]
- In individually negotiated contracts, the representations and warranties are required to be valid both at the time of signing and at the time of closing.[40] Furthermore, all the pre-closing covenants must have been performed or fulfilled prior to the closing.
- The availability of funding is a core condition in individually negotiated transactions.
- The acquirer will want to obtain control over the shares or assets. In share deals, the acquirer will often require a mimimum share block that confers particular majority rights such as the right to amend articles of association or squeeze-out rights.
- The acquirer will also require the receipt of all necessary government approvals and third party consents.

Conditions precedent normally contain even the following conditions:

- receipt of legal opinions and other closing documents; and
- satisfactory completion of the prospective acquirer's due diligence of the target's business.

The acquirer should always prefer an option to finalise the transaction even when conditions precedent have not been fulfilled.

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[39] See, for example, Goldberg L, Acquisition Agreements from a Business Perspective (Principal Focus: Private Company Acquisition for Cash). In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice, Corporate Law and Practice Course Handbook Series. New York City (2008) pp 216–218.

[40] Phillips J, Runnicles J, Schwartz J, Navigating trans-atlantic deals: warranties, disclosure and material adverse change, JFRC 15(4) (2007) pp 479–480: "In the USA, the practice is invariably to require warranties and representations to be repeated as at closing, and usually the accuracy of warranties/representations at closing is a condition to closing. In the UK, while it is not uncommon for warranties to be repeated at closing, sellers will seek to resist that principle and at worst argue for repetition of only those warranties over which they have direct control. In addition, in the UK, it remains unusual for the accuracy of all warranties at closing to be a pre-condition of closing. In some UK deals, the buyer may have the right to terminate as a result of a material breach of the warranties given at signing and, in some cases, as repeated at closing."

Conditions precedent and "best efforts". Conditions precedent can, in practice, give a party ample discretion. For this reason, a condition precedent is often complemented by a "dynamic" component setting out how that discretion may be used (Volume II). For example, where a party does not have any obligation to close on the transaction unless it has obtained the necessary debt financing, the vendor may ask for a covenant that the acquirer would use its "best efforts" to obtain the financing.

Particular remarks: material adverse change clause. MAC clauses can be used in many ways in a business acquisition contract. A MAC clause can be a condition precedent to closing, a warranty, or an information covenant. Material adverse change can also trigger different sanctions depending on the context in which it is used. The agreed sanctions can include no-closure, repudiation of the contract (when it already has been closed), adjustment of the price, and damages.[41] MAC clauses can also be general and specific.

A general MAC clause typically entitles the acquirer to terminate or not to close in circumstances where the economic position of the target has been materially and adversely affected. Specific MAC clauses entitle the acquirer to terminate or not to close if a specified event occurs; the idenfication of specific factors that may give rise to a MAC will reduce the risk inherent in interpretation.[42] The acquirer frequently seeks to include a MAC clause, whether expressed as a condition or as a termination right. The vendor will resist MAC clauses provisions on the basis that the vendor requires certainty that the deal will close.[43]

The circumstances that can be regarded as a material adverse change depend on the contract and the governing law. For example, whether the future business prospects of the target will be covered by the MAC clause or excluded from its scope tends to depend on the bargaining power of the parties.[44]

Material adverse change being an Anglo-American concept, there is plenty of case law in common law countries but in the interpretation of MAC clauses but little case law in continental Europe.[45]

In the US, the Model Stock Purchase Agreement published by the Committee on Negotiated Acquisitions of the Section of Business Law of the American Bar Association contains the following definition of MAC: "Since the date of the Balance Sheet, there has not been any material adverse change in the business, operations, properties, prospects, assets, or condition of any Acquired Company, and no event has occurred or circumstances exists that may result in such a material adverse change." This is nevertheless a circular definition as it relies on the concept of material adverse change.

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41 Schlößer D, Material Adverse Change-Klauseln in US-amerikanischen Unternehmenskaufverträgen, RIW 12/2006 pp 891 and 897.

42 See, for example, the judgment of the Delaware Court of Chancery in Frontier Oil Corp. v. Holly Corp., No. Civ.A. 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005).

43 See Phillips J, Runnicles J, Schwartz J, *op cit*, p 480.

44 Schlößer D, *op cit*, p 894.

45 *Ibid*, p 890.

According to US case-law, an objective test must be used. The perspective is that of a reasonable acquirer. At least where the acquirer is a long-term investor, the change must be significant and relate to the long-term health of the target's business.

In the US, *IBP Inc. v. Tyson Foods, Inc.* is a leading case interpreting material adverse effect (MAE). In this merger case, the acquirer had sought to rely on a broadly drafted MAC clause. The Delaware Court of Chancery nevertheless ordered those two companies to complete the merger. The court held that a merger party would be entitled to exercise a standard MAE clause only when the other party had suffered a significant change in the long-term health of its business.[46] In England, a significant drop in the value of the target's assets would not necessarily by regarded as a MAC by the court, unless the explicit terms of the contract provide otherwise (see also Volume II).[47]

The other party can propose materiality thresholds based on quantitative criteria and exceptions (carve-outs) to qualify the MAC clause and to mitigate its effects.

In the US, the traditional MAC exceptions include: "change in the economy or business in general"; "change in the general conditions of the [specified] industry"; "effect of announcement of the transaction"; "changes in GAAP"; and "change caused by the taking of any action required or permitted or in any way resulting from or arising in connection with the agreement".[48]

Pre-closing covenants. In addition to conditions precedent to closing, the parties agree on pre-closing covenants. Pre-closing covenants are a series of promises about how the parties will behave during the interim between the time the agreement is signed and the closing.[49]

The behaviour or the target is particularly important to the acquirer. The pre-closing covenants of the vendor are intended to ensure that the acquirer gets the benefit of its bargain. Furthermore, the incurrence of new debt, acquisitions and capital expenditure are likely to influence the financing of the acquisition.

Typically, the target is permitted to take actions in the ordinary course of business but prohibited from doing anything else. Normally, certain major acts will be

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[46] IBP Inc. v. Tyson Foods, Inc., 2001 Del. Ch. LEXIS 81 (June 15, 2001). The Delaware Court of Chancery said: "Merger contracts are heavily negotiated and cover a large number of specific risks explicitly. As a result, even where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror." For the effects of this judgment, see also Schlößer D, *op cit*, p 896.

[47] Apart from the practice of UK Takeover Panel, there is not much case law on the subject of MAC clauses in England. See nevertheless Levinson v Farin [1977] 2 All ER 1149 (a reduction in the net asset value of the target in the region of 20%).

[48] Nixon Peabody LLP, Fifth Annual MAC Survey (www.nixonpeabody.com).

[49] See Bainbridge SM, *op cit*, pp 175–177.

expressly forbidden, such as changes to the articles of association or other constitutional documents of the company, and the distribution of assets to shareholders.

The management of the target can object to significant restrictions on management discretion. In practice, pre-closing covenants are often diluted. For example, some actions can be permitted with the acquirer's consent which may not unreasonably be withheld.

Pre-closing covenants can include undertakings that secure the exclusivity of the transaction. The enforceability of such covenants depends on their contents and the governing law (section 12.4.3).

12.6 Employee Issues

Acquisitions raise various employee issues. Employees have individual and collective rights. They are entitled to a pension. They also know everything about the target's business and how to compete with the target. Some of them participate in the acquisition process. This makes it necessary to manage employee issues at various levels.

Management of information. The management of confidentiality through non-disclosure and non-competition agreements belongs to the most important components of the pre-signing process (section 12.2). As has been explained earlier, non-disclosure agreements and non-competition clauses do not guarantee sufficient protection in Europe (Volume I).

Non-solicit/no-hire covenants. If the vendor can hire the core employees of the target business after closing, the acquirer might not receive the benefit of its bargain. The parties often agree that the vendor may neither solicit nor hire target employees after the closing of the agreement. Such an obligation can also support a non-competition covenant (section 16.3).

Payments to the target's board and executives. After closing, the acquirer will try to encourage vital target management to stay on. (a) The acquirer will have to ensure that proper employment contracts are in place. (b) The acquirer can also use additional incentives. For example, the acquirer may offer to pay a stay-on bonus to key executives in cash and/or shares. Typically, the bonuses will be paid over a period of time, but the executive will not be entitled to any unpaid portion of the stay-on bonus unless he is employed by the firm at the time a payment is to be made in accordance with the terms of the bonus.

In private-equity acquisitions, key management is frequently asked to invest in the shares of the acquisition vehicle or the target company. The private-equity firm may invite management and board members to be co-owners and align their interests with those of the private-equity firm for two reasons. First, refinancing after the completion of the acquisition depends on the co-operation of the target's board and management. For example, the distribution of funds to shareholders and the merger of the target with the acquisition vehicle require the consent of the target's board. The amount of capital that can be released and distributed to shareholders depends on the creativity of the target's management. Second, as the target

will be loaded with debt after refinancing, the most important task of the target's management is to keep the firm alive. The worst-case scenario is that: the target becomes insolvent after refinancing; the earlier distributions will be held illegal; and the earlier distributions must be returned under insolvency laws.

Where the target's board members or executives act as buyers or co-buyers, the independency of corporate decision-making will typically be governed by particular rules.[50]

It is legally problematic for the acquirer to make any promises about future payments to the target's board and executives unless the acquisition already has been completed or the target has given its consent. Such payments can be unethical for obvious reasons. Depending on the governing law, even the target's board may be prohibited from promising any additional benefits to the firm's own board members or executives.

In the famous *Mannesmann* case, the regional court of Düsseldorf ruled in 2004 that manager bonuses, promised by the supervisory board of Mannesmann to Mannesmann executives in the context of the takeover of Mannesmann by Vodafone, were unreasonable and therefore illegal under the Aktiengesetz.[51] They were unreasonable, because they had been granted retrospectively and did not relate to pre-set performance targets.

Community law. The employees of the particating companies may have rights under Community law in the context of acquisitions. Those rights consist of collective rights and individual rights.

Individual rights of the employees of a transferred undertaking. Directive 77/187/EEC is intended to safeguard the rights of workers in the event of a change of employer by making it possible for them to continue to work for the new employer on the same conditions as those agreed with the transferor.

The purpose of the Directive is to ensure, as far as possible, that the contract of employment or employment relationship continues unchanged with the transferee, in order to prevent the workers concerned from being placed in a less favourable position solely as a result of the transfer.[52]

The Directive achieves this by providing that the "transferor's rights and obligations arising from a contract of employment or from an employment relationship existing on the date of a transfer … shall, by reason of such transfer, be transferred to the transferee. Member States may provide that, after the date of transfer … and in addition to the transferee, the transferor shall continue to be liable in respect of obligations which arose from a contract of employment or an employment relationship."[53]

The Directive applies to the transfer of an undertaking, business or part of a business to another employer as a result of a legal transfer or merger. According to the case-law of the ECJ, the Directive applies where there is a change in the legal

[50] See, for example, § 112 AktG: "Vorstandsmitgliedern gegenüber vertritt der Aufsichtsrat die Gesellschaft gerichtlich und außergerichtlich."
[51] § 87(1) AktG.
[52] For example, Case C-478/03 Celtec [2005] ECR I-4389, paragraph 26.
[53] Article 3(1) of Directive 77/187/EEC.

or natural person who is responsible for carrying on the business, regardless of whether or not ownership of the undertaking is transferred. The decisive criterion for establishing whether there is a transfer for the purposes of this Directive is whether a new employer continues or resumes the operation of the unit in question, retaining its identity.[54]

According to case-law, the implementation of such rights conferred on employees may not be made subject to the consent of either the transferor or the transferee nor to the consent of the employees' representatives or the employees themselves.[55]

This means that contracts of employment, or employment relationships, existing on the date of the transfer between the transferor and the workers assigned to the undertaking transferred are automatically transferred from the transferor to the transferee by the mere fact of the transfer of the undertaking.[56]

There is only one exception. Following a decision freely taken by the worker himself, he is at liberty, after the transfer, not to continue the employment relationship with the new employer.[57]

Collective rights. The collective rights of employees consist of the employer's obligations to inform or consult the employees' recognised representatives under Community and national law. This means that there must be a labour law compliance process in addition to a competition law and other compliance processes.[58]

The national rules on employees' representatives are involved in decision-making within companies depend very much on the Member State. There is great diversity of rules and practices.[59] For example, German law requires strict compliance with extensive duties of disclosure.[60]

However, EU merger and takeover law protects even the interests of employees. In addition, the collective rights of employees are based in particular on the European Works Council Directive (EWC Directive).[61]

Mergers and public takeover bids. Both domestic and cross-border mergers are covered by a legal regime for informing and consulting employees. Rules on in-

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[54] Article 1(1) of Directive 77/187/EEC. See, for example, Case C-478/03 Celtec [2005] ECR I-4389, paragraphs 33–35; Case C-458/05 Jouini et al [2007] ECR I-7301, paragraphs 23–27 and 31–32.

[55] Case C-478/03 Celtec [2005] ECR I-4389, paragraph 37.

[56] Case C-478/03 Celtec [2005] ECR I-4389, paragraph 38.

[57] Case C-478/03 Celtec [2005] ECR I-4389, paragraph 37. For the lack of rules on financial compensation, see C-396/07 Mirja Juuri v Fazer Amica Oy.

[58] See also recital 45 of Regulation 139/2004 (EC Merger Regulation): "This Regulation in no way detracts from the collective rights of employees, as recognised in the undertakings concerned, notably with regard to any obligation to inform or consult their recognised representatives under Community and national law."

[59] Recital 5 of Directive 2001/86/EC.

[60] § 613a BGB. See also BAG, judgment of 20.3.2008 – 8 AZR 1016/06.

[61] Directive 94/45/EC on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees (as amended).

formation and consultation can be found not only in EU labour law[62] but also in EU company law and capital markets law.

For example, the likely effects of the merger on employment will have to be addressed in the draft terms of merger[63] and in the report of the management or administrative organ submitted to the general meeting.[64] In public takeover bids, both the offeror and the offeree must disclose information about the effects of the takeover on employment.[65]

In cross-border mergers, employees' participation rights raise further legal questions, because the existing participation rights of employees can range from a mandatory co-determination regime in Germany and the Netherlands to essentially no participation rights in England. EU merger law has adopted a before-after principle, according to which existing participation rights should be preserved after the merger.[66] For SEs, the before-after provisions are based on the provisions of Directive 2001/86/EC.[67] For other limited-liability companies, the before-after provisions are based on the Directive on cross-border mergers.[68]

In cross-border mergers, the competent authorities will scuritinise even the legality of the arrangements for employee participation.[69]

SE. SEs are subject to a more regulated employee involvement regime. Directive 2001/86/EC is designed to ensure that employees have a right of involvement in issues and decisions affecting the life of their SE.[70]

There is an information and consultation procedure at transnational level in all cases of creation of an SE.[71] The SE Regulation contains numerous rules on the information and consultation of employees.[72]

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[62] According to recital 12 of Directive 2005/56/EC (Directive on cross-border mergers), employees' rights other than rights of participation should remain subject to the national provisions referred to in Directive 98/59/EC on collective redundancies, Directive 2001/23/EC on the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses, Directive 2002/14/EC establishing a general framework for informing and consulting employees in the European Community, and Directive 94/45/EC on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees. See also recital 23 of Directive 2004/25/EC (Directive on takeover bids).

[63] Article 5(d) of Directive 2005/56/EC (Directive on cross-border mergers); Article 32(2) of Regulation 2157/2001 (SE Regulation).

[64] Article 7 of Directive 2005/56/EC (Directive on cross-border mergers).

[65] Articles 3(1)(b), 4(2)(e), 6(1), 6(2), 6(3)(i), 8(2), 9(5) and 14 of Directive 2004/25/EC (Directive on takeover bids).

[66] Recital 7 of Directive 2001/86/EC; recital 13 of Directive 2005/56/EC (Directive on cross-border mergers).

[67] See in particular Articles 4 and 7.

[68] Article 16 of Directive 2005/56/EC (Directive on cross-border mergers).

[69] Article 11 of Directive 2005/56/EC (Directive on cross-border mergers).

[70] Directive 2001/86/EC supplementing the Statute for a European company with regard to the involvement of employees. Recital 21 and Article 1(4) of Regulation 2157/2001 (SE Regulation).

[71] Recital 6 of Directive 2001/86/EC.

After the founding of the SE, the participation rights of its employees are governed by the before-after principle. This principle means that participation rights which exist within one or more companies establishing an SE should be preserved through their transfer to the SE, unless the parties decide otherwise.[73]

This means that the mandatory co-determination regime applied to a German AG under German law does not apply to an SE. This can be illustrated by the Porsche case. In 2007, Porsche AG was a company with friendly unions. Before attempting to acquire full control of Volkswagen AG, a company with powerful unions hostile to Porsche, Porsche AG decided to form a holding SE under the SE Regulation.[74] This enabled the management of Porsche AG to agree on the terms of employee participation in the new holding company, Porsche Automobil Holding SE, with friendly unions.[75] The idea was that the subsequent acquisition of Volkswagen AG would not influence the form of employee involvement.[76]

European Works Council. The purpose of the EWC Directive is to improve the right of employees in Community-scale undertakings and Community-scale groups of undertakings to be informed and consulted. A Community-scale undertaking means any undertaking with at least 1 000 employees within the Member States and at least 150 employees in each of at least two Member States.

The EWC Directive requires the establishment of a European Works Council or a procedure for informing and consulting employees in every Community-scale undertaking and every Community-scale group of undertakings.

In addition to their other rights to be informed and consulted, European Work Councils have a right to be informed where there are exceptional circumstances affecting the employees' interests to a considerable extent. In particular, such circumstances may exist in the event of relocation, closure or collective redundancy.[77]

The EWC Directive gives employees' representatives in unions and national works councils the opportunity to consult with each other and to develop a common European response to the employers' transnational plans. The management must consider employees' response before those plans are implemented.

The EWC Directive lays down a confidentiality obligation[78] and provides for an escape: there is no obligation to "transmit information when its nature is such that,

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[72] Regulation 2157/2001 (SE Regulation): recitals 19 and 21 as well as Articles 1(4), 8(3), 12, 20(1)(i), 23(2), 26(3), 29(4), 32(2), 32(6), and 37.

[73] Recital 7 of Directive 2001/86/EC.

[74] Articles 2(2) and 32 of Regulation 2157/2001 (SE Regulation).

[75] Article 3(3) of Directive 2001/86/EC: "The special negotiating body and the competent organs of the participating companies shall determine, by written agreement, arrangements for the involvement of employees within the SE …" See also Arbeitsgericht Stuttgart, judgment of 29.4.2008 (12 BV 109/07) (VW/Porsche).

[76] See nevertheless § 18 SEBG. See also Amann M, Porsche, VW und die Juristen, FAZ, 23 September 2008 p 22.

[77] Directive 94/45/EC (EWC Directive), Annex, paragraph 3.

[78] Article 8(1) of Directive 94/45/EC (EWC Directive).

according to objective criteria, it would seriously harm the functioning of the undertakings concerned or would be prejudicial to them”.[79]

[79] Article 8(2) of Directive 94/45/EC (EWC Directive).

13 Due Diligence and Disclosures

13.1 General Remarks

Business acquisitions belong to the largest transactions that the firm will make, and they are individually-negotiated. This increases the importance of information management, due diligence, and disclosures. At a general level, two large legal topics are of particular interest in the context of due diligence and disclosures: legal risks related to due diligence and disclosures as such (in particular, the qualification of representations and warranties); and legal risks related to the target (in particular, the target firm's legal framework).

Qualification of representations and warranties. It is characteristic of European contract laws that all information in whatever form and from whatever sources is deemed to qualify all representations and warranties. In effect, legal background rules under European contract laws protect the vendor.

A practical application of those rules is that the vendor may try to present a massive amount of information at a late stage just before the conclusion of the contract. The buyer should either analyse the disclosed information within a very short period of time, or manage this problem by careful drafting.

The acquirer can use certain tools and practices to manage the problem of general qualification of representations of warranties.

First, the acquirer should do everything that it should always do to manage the attribution of incoming information and to mitigate the risk that firm is deemed to know something (Volume I).

Second, the acquirer should ensure very early on in the negotiations that the parties agree on: the express terms of the disclosure process; the disclosure channels; the form of disclosures; the requirement that disclosures may only qualify representations and warranties to which they are specifically referenced; and minimum requirements for disclosures that will qualify representations and warranties.

Third, the acquirer should, simultaneously, agree on: a general obligation to disclose information in good faith and in a timely manner; and a general standard for disclosures.

In the US, statements that qualify representations and warranties tend to be more specific. There is a reference to each warranty and representation that the statement seeks to qualify.

The target firm's legal framework. The second legal topic relates to the target. Basically, the prospective acquirer would need information about the target firm's

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legal framework in order to assess cash flow and legal and other risks properly. However, this can be difficult.

Like the acquirer's own legal framework, the target's legal framework is both vast and complicated. Furthermore, legal risks range from general legal risks to contributory legal risks, and can be difficult both to identify and to assess.

This can be illustrated by insurance cover. Like any companies, the target should have a risk management program. Even the most basic risk management programs tend to address the question of insurance cover. It would be difficult to evaluate the target's cover in a reliable way, because one would have to understand the target's business, collect all relevant policy documents from all jurisdictions, analyse the wordings in detail, decide the law applicable to each policy, and apply the insurance and general law of that place to the wording. Often, the acquirer will only review the summary of insurance cover, compiled by the vendors or by the target's insurance broker. In practice, the acquirer will not review the actual policies themselves but hopes to rely on a warranty that the target has "adequate" insurance cover in place. Furthermore, if the acquirer actually tried to study the target's insurance documents, the vendor's warranties would be qualified by disclosure (see above).[1]

13.2 Due Diligence in Practice

Each party should inspect the target. In practice, the form of inspections is more or less standardised. These standardised inspections are called due diligence. Due diligence has different objectives depending on: by whom it is performed (the vendor, the target, the acquirer); when it is performed (before solicitating offers, before signing, before closing, after closing); and its nature (legal, financial, other).

Vendor due diligence. The vendor should perform a due diligence inspection before entering into detailed talks with the potential acquirer. The purpose of vendor due diligence is to prepare the target for sale and to speed up the process.[2]

A vendor due diligence enables the vendor to: decide what to sell and what to leave out; decide how to structure the transaction; decide on price or how price should be determined; avoid giving information that is not accurate; avoid promises that it cannot keep; avoid breaches of contract; fix things that can be fixed (in particular documentation and permits); take care of time-consuming things such as environmental inspections in advance (and speed up negotiations); reduce buyer's uncertainty (and risk) and obtain a better price; and avoid "deal breakers" and the risk that the buyer becomes disappointed during contract talks and walks away (and uses information disclosed by the seller and the target for its own competing business purposes).

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1 See Napier C, Evenett H, Insurance in Cross-border Acquisitions: Investigation of Cover and Assessment of Exposures, Int Ins L R 3(11) (1995) pp 383–388.

2 See Vandrill R, Legal Due Diligence in Private Equity Transactions, Int Comp Comm L R 13(8) (2002) pp 292–293.

In practice, vendor due diligence is necessary before the vendor can organise the data room. The establishment of a data room has the advantages of minimising disruption to target management and the vendor.

Buyer due diligence. The purpose of buyer due diligence is to avoid bad acquisitions, to ensure that the target and the obligations of the vendor are what the buyer wants to bargain for, and not to pay too much.[3]

Buyer due diligence before closing thus enables the buyer to: avoid buying "a pig in the bag" (something without seeing it first); decide what to buy (and leave too large risks outside); decide on the necessary contract terms (seller's representations and warranties, covenants etc); decide on price or how the price should be determined; and find out about the existence of "deal breakers".

The buyer will normally get an opportunity to perform a due diligence inspection on two or more occasions depending on the structure of the negotiations. For example, prospective bidders may be able to verify the contents of the vendor's initial offer memorandum by means of a data room after undertaking customary non-disclosure obligations. One or more select bidders will be given a chance to perform a more thorough due diligence inspection before the vendor signs the acquisition agreement, and a further due diligence before closing to verify that the target is what the vendor promised. After obtaining control, the buyer may have to perform a last due diligence in order to find out whether there are misstatements or a breach of contract by the vendor.

Legal due diligence. The purpose of legal due diligence performed by the buyer depends on the stage of the negotiations. The most important purpose of legal due diligence is to discover the relevant legal framework to which the target is subject. Towards the end of the negotiations and, in particular, after the signing of the acquisition agreement, legal due diligence will also be a means to verify the representations and warranties of the vendor. For the vendor, legal due diligence is usually part of the pre-negotiation planning exercise.[4]

Lender due diligence. A bank will not commit to lending money to the acquirer without detailed information about the transaction. Virtually all external funding arrangements are subject to the favourable outcome of a due diligence inspection by investors. Where the acquirer issues shares, an investment bank will perform due diligence (section 5.10.2). Where the acquirer raises debt funding, it will be performed by one or more of the lenders (section 20.5.2). Before a due diligence inspection, a bank cannot be expected to promise more than a vague commitment letter (section 20.5.2).[5]

Structure and contents of due diligence. Generally, the structure and contents of due diligence inspections depend on three things: objectives relating to the man-

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[3] For an example of buyer due diligence, see Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 177–179.

[4] See, for example, Vandrill R, *op cit*, pp 291–292.

[5] Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 2 number 22; Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) pp 301–303.

agement of information; the structuring of the negotiation process; as well as legal requirements and legal constraints.

Management of information. Due diligence is a means to manage information (generally, see Volume I). Both the vendor and the acquirer must manage incoming information and outgoing information.

The *acquirer* needs to obtain useful information about return and risk for its investment. As the target and the vendor can be expected to know more about the target than the acquirer does, the acquirer will also need to mitigate risks caused be information asymmetries. If the acquirer knows little about the target, it cannot be expected to pay much.

The *target* needs to protect its confidential information in case the negotiations fail. However, it may also need to ensure that a preferred acquisition will materialise. For this purpose, the target needs to ensure that the acquirer obtains useful information. The more the acquirer knows about the target, the more likely it is to pay a price that reflects the true value of the target.

For the same reasons, the *vendor* will need to ensure that the acquirer obtains useful information. The vendor also has an interest in protecting its own and the target's confidential information in case the negotiations fail.

On the other hand, where the vendor and the target are not the same, they may have conflicting interests and different information-related incentives even where the vendor owns all shares in the target. The target has typically more powerful incentives to protect its confidential information. Members of the target's board and its management owe wide-ranging duties to the company and wide-ranging duties to comply with laws that govern the company's business. It is the duty of the target's board and management to manage outgoing information and keep the target company's confidential information confidential. A shareholder typically both owes fewer duties and benefits from the separate legal personality of the target company.

As a rule, if the target and the vendor are not the same, the vendor will therefore prefer to disclose more information about the target, and the target's board and management have stronger legal incentives to keep the target's confidential information confidential.

Because of legal rules on the liability of a party for information disclosed by it and legal rules on the effects of disclosed information on the contents of contractual obligations (see section 16.2 and Volume II), both the target's representatives and the vendor need useful information about the target in order to know what to disclose and to assess the quality of their own disclosures.

The structuring of the negotiation process. The structuring of the negotiation process plays a role. All parties (acquirer, vendor, target, lender) tend to carry out due diligence inspections in a privately-negotiated asset deal. In contrast, where a company issues shares to the public and its shares are subscribed for by retail investors, only the issuer and its advisers as well as the parties responsible for the prospectus can carry out due diligence inspections (the investors having neither legal rights nor economic resources to do so).

Generally, the structure and contents of due diligence inspections (and disclosure of information in general) on one hand and the process of making the contract

binding on the other are interrelated. This can be illustrated by the following three situations. (1) Before concluding a binding agreement that automatically leads to the acquisition of the target, the acquirer will require plenty of useful information. (2) In contrast, before concluding an agreement that neither forces it to acquire the target nor influences the terms of the acquisition agreement, the acquirer will require less useful information. (3) Therefore, if the parties have separated signing and closing, the acquirer's information needs before signing depend on many things. (a) The acquirer needs useful information about the target in order to know what particular issues it should address and what terms the parties should fix in the agreement to be signed by the parties. The flexibility of contract terms at signing will therefore play a role. (b) If the terms of the acquisition agreement are fixed at signing, the acquirer will need more useful information before signing. (c) If the parties at signing agree on flexible terms that will be fixed at closing, the acquirer needs less useful information before signing but additional information before closing.

In addition, due diligence and conditions precedent to closing should be interrelated. (a) Where the acquirer already has carried out a complete due diligence inspection before signing and the contract terms have been fixed at signing, the acquirer is sufficiently protected although the acceptable outcome of a due diligence inspection is not made a condition precedent to closing. It is sufficient to verify that the representations and warranties of the vendor/target are true at the time of closing and that other conditions precedent to closing are met. (b) Where the acquirer either did not or was not given the opportunity to carry out a complete due diligence inspection before closing, the acquirer is not sufficiently protected unless the acceptable outcome of a due diligence inspection is made a condition precedent to closing.

Due diligence, disclosures and warranties tend to be interrelated as well. The relation between due diligence, disclosures and warranties have been described by UK and US lawyers as follows, whereby the practice and mechanism for disclosures in the UK are arguably more favourable to the seller compared with those applied in the US:[6]

"In the UK, disclosures against the warranties are typically contained in a separate Disclosure Letter, rather than in the schedules to the agreement itself, as is sometimes the case in the USA. The Disclosure Letter usually contains 'general' disclosures (for example, matters that appear in public records), which quality all warranties, and "specific" disclosures, which, although usually cross-references to specific warranties, are often treated as effective disclosures in relation to all warranties (whether or not specifically references to a particular warranty).

The Disclosure Letter invariably has annexed to it a large volume of documents (often called 'the Disclosure Bundle'), some (but not all) of which are include because they are expressly referred to in the Disclosure Letter itself. The seller almost invariably seeks to treat the entire contents of the documents contained in the Disclosure Bundle as disclosed in relation to all the warranties. In some cases (particularly auction sales), the seller also

[6] Phillips J, Runnicles J, Schwartz J, Navigating trans-atlantic deals: warranties, disclosure and material adverse change, JFRC 15(4) (2007) pp 475–476.

seeks to treat as generally disclosed in relation to all warranties/representations the contents of the documents contained in the data room (if there is one); buyers will usually resist wholesale disclosure of a data room.

US convention has been for the buyer to allow specific disclosures only in respect of each warranty and representation against which disclosure is being made. General disclosures are not common, and a buyer under a US agreement will commonly seek to provide in the agreement that specific disclosures are not treated as effective disclosures in relation to any warranty unless specifically cross-references."

Legal requirements and legal constraints. The legal requirements and legal constraints tend to be complicated. There are different legal requirements and different legal constraints for different parties and depending on the context. It can therefore be difficult to identify all legal requirements and legal constraints. It can also be difficult to interpret the legal rules identified and apply them in a concete situation. Some legal requirements and legal constraints will be discussed in the following.

13.3 Legal Requirements and Legal Constraints

13.3.1 General Remarks

Basically, the legal requirements and legal constraints always depend on the identity of the *person by whom* disclosure is to be made and the identity of the *person to whom* disclosure is to be made (Volume I). It is also necessary to distinguish between *different kinds of norms*: (a) a right to disclose information; a duty to disclose information; a duty not to disclose information; as well as (b) a right to ask for information; a right to receive information; a duty to ask for information; a duty not to ask for information; and a duty not to use information received.

Such rights and obligations are typically based on *different legal sources* depending on the identity of the parties and the circumstances (see below).

It is also worth noting that the actions of a party are constrained not only by legal rules that apply to that *party* but also by the personal duties of its own *representatives* who are expected to comply with their own personal obligations (for compliance, see Volume I).

Information rights and duties. Information rights and obligations are typically based on different legal sources depending on the identity of both parties and the circumstances. In the context of business acquisitions, the core parties are the acquirer, the vendor, the target, as well as members of the corporate organs of each party. Five situations will be briefly studied in the following:

- *vendor* due diligence from the perspective of the *vendor*;
- *buyer* due diligence from the perspective of the *vendor*;
- *buyer* due diligence from the perspective of the *target's board*;
- *buyer* due diligence from the perspective of the *buyer*; and
- *buyer* due diligence from the perspective of the *buyer's board*.

13.3.2 Vendor Due Diligence, Vendor's Perspective

For legal reasons, it is in the interests of the vendor to perform its own due diligence inspection. Vendor due diligence is a central way to mitigate three important risks: the risk of the vendor's own breach of contract; the risk that the vendor is deemed to know something (section 16.2); and the risk of non-compliance with mandatory provisions of law.

In an asset deal, it is relatively easy to assume that the vendor has actual or constructive knowledge of things closely related to the target. In a share deal, the same can be said of the controlling shareholder.

Actual or constructive knowledge by the vendor can increase the obligations of the vendor because of a wide range of rules on issues such as: fraud; pre-contractual duties of good faith and similar pre-contractual duties; disclosure; the interpretation of contractual obligations; and liability for damage caused by negligence.

The vendor can therefore mitigate the risk of breach of contract by verifying information that it has received from target management before passing it on to the prospective acquirer.[7]

Vendor due diligence also helps the vendor to know what to say and what not to say. Disclosures can be constrained by mandatory provisions in many areas of law.[8] For example, all listed firms are subject to an extensive information regulation regime (see Chapter 19).

Under English law, the vendor will have three particular legal reasons to avoid misstatements and withholding of information: section 397 of the Financial Services and Markets Act 2000; section 2(1) of the Misrepresentation Act 1967; and section 19 of the Theft Act 1968.[9]

13.3.3 Buyer Due Diligence, Vendor's Perspective

For legal reasons, it is in the interests of the vendor to let the acquirer perform a due diligence inspection. From the perspective of the vendor, buyer due diligence is a way to reduce the responsibility of the vendor for the actual specifications of the target. It is a general rule of contract law that where a contract party had actual or constructive notice of certain circumstances at the time of contracting, that contract party cannot invoke their existence as breach of contract.

CISG Article 35(3) provides that the seller is not liable for any lack of conformity of the goods if at the time of the conclusion of the contract the buyer knew or could not have been unaware of the lack of conformity. In addition, CISG Article 38(1) requires the buyer to ex-

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[7] Vandrill R, *op cit*, p 293.

[8] For English law, see Vandrill R, *op cit*, p 293.

[9] See Vandrill R, *op cit*, p 293.

amine the goods, or cause them to be examined, within as short a period as is practicable in the circumstances.

Vendor's right to permit buyer due diligence. As a rule, the vendor can permit buyer due diligence of the object in an asset deal.

Whether such a contract is binding depends on through whom the buyer has dealt with the vendor (for representation, see Volume II). For example, a lowly employee does not have implied authority to permit buyer due diligence, but a contract on the performance of a due diligence inspection is usually binding where the buyer has dealt with the vendor through its statutory "organs".[10]

The internal decision-making of the vendor depends on the applicable company law and the internal rule-making of the vendor (articles of association, internal guidelines, internal decisions). Typically, a significant due diligence inspection may not be decided on by the vendor's sub-board executives but requires authorisation by the statutory board.

In a share deal, buyer due diligence of the target requires the target's permission. Where the vendor and the target are not the same, the vendor can, for example, undertake to procure that the buyer can perform a due diligence inspection of the target.

Vendor's duty to permit buyer due diligence. As a rule, the vendor does not have a duty to permit buyer due diligence. Sometimes there is such a duty. This is the case where the duty is based on a binding agreement between the parties (see above). In a share deal, the main rule is that the target is not a contract party.

In rare cases, the vendor might have a duty to conclude an agreement permitting buyer due diligence. For example, where two shareholders bid for the target's shares, permitting buyer due diligence by one but not by the other might be regarded as a breach of the principle of equivalent treatment of shareholders in the same position depending on the governing law (Volume I).[11]

Also in rare cases, the vendor may have a duty to disclose the same information to the public. The Directive on market abuse requires "complete and effective public disclosure" of inside information disclosed selectively to any third party "in the normal exercise of his employment, profession or duties", unless "the person receiving the information owes a duty of confidentiality, regardless of whether such duty is based on a law, on regulations, on articles of association or on a contract".[12] Such a public disclosure will nevertheless not amount to a duty to permit a due diligence inspection.

Vendor's duty not to disclose information to the buyer. Buyer due diligence is sometimes constrained by the duty of the vendor not to disclose information to the buyer.

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[10] Article 9(1) of Directive 68/151/EEC (First Company Law Directive).

[11] See, for example, § 53a AktG.

[12] Article 6(3) of Directive 2003/6/EC (Directive on market abuse).

In both asset deals and share deals, such a duty can be based on non-dislosure obligations under third party contracts. Breach of non-disclosure obligations owed to a third party can trigger sanctions for breach of contract.

In both asset deals and share deals, a duty not to disclose information to the buyer can also be based on mandatory provisions of law protecting third parties such as customers and employees. For example, legal rules on privacy, data secrecy, and bank secrecy limit the right to disclose information to potential buyers (Volume I).

Where the target is a company whose shares have been admitted to trading on a regulated market, rules on inside information can restrict disclosure of information (Chapter 19). First, the Directive on market abuse lays down an obligation for Member States to prohibit persons who possess inside information from "recommending or inducing another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates".[13] This can act as a constraint on the disclosure of information in a share deal (but not in an asset deal). Second, Member States also have a duty to "prohibit any person … who possesses inside information from using that information by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates".[14] This can act as a constraint on the use by the buyer of information selectively disclosed in a share deal (but not in an asset deal).

Particularly in share deals (in which the vendor and the target are not the same), mandatory provisions of law can restrict the unauthorised disclosure of the target's trade secrets to a third party.

Vendor's right to ask for information. The vendor cannot disclose information that it neither possesses nor can obtain. In a share deal, the vendor does not have automatic access to the books and other internal information of the target (as the vendor and the target are not the same entity). For example, a shareholder has a limited right to ask for information at the general meeting of a German AG,[15] but the board may refuse to give information under some circumstances.[16] If the board has made a selective disclosure to one shareholder, the same information must be disclosed to the general meeting.[17] In a German GmbH, a shareholder may ask for access to the books of the company,[18] but the managing directors may refuse to permit access under some circumstances.[19] In any case, the exercise of such shareholder rights may not be transferred or delegated to the prospective buyer of shares.

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[13] Article 3(b) of Directive 2003/6/EC (Directive on market abuse).
[14] Article 2(1) of Directive 2003/6/EC (Directive on market abuse).
[15] § 131(1) and 131(2)AktG.
[16] § 131(3) AktG.
[17] § 131(4) AktG.
[18] § 51a(1) GmbHG.
[19] § 51a(2) GmbHG.

13.3.4 Buyer Due Diligence, Target's Board

The interests of the target's board are directly influenced by board members' own legal duties (such as their duty of care, fiduciary duties, and duties under securities markets laws) and indirectly influenced by the interests of the target (which board members must take into account in order to comply with their duties). There is no contractual relationship between the target's board and the buyer.

The right of the target's board to permit buyer due diligence. The internal power to decide whether to permit buyer due diligence is based on the rules that govern the internal distribution of power in general. Typically, the board of directors or, when the company has a statutory two-tier board, the management board is empowered to decide on most management matters and therefore also on buyer due diligence. Even sub-board executives can have such a right depending on the governing law, the company, and the circumstances.

For example, Nordic company laws provide for a managing director (CEO) who is responsible for the day-to-day management of the company. While the managing director is not empowered to decide on unusual and important things such as the sale of an important part of the company's business, the CEO may be empowered to permit buyer due diligence as part of day-to-day management when the board already has decided to enter into talks with the prospective buyer.

The duty of the target's board to permit buyer due diligence. As a rule, the board of the target has no duty to permit buyer due diligence as such.

On the other hand, failure to permit buyer due diligence can, in practice, mean that the negotiations will fail or that the price will reflect the buyer's higher risk exposure. It can be in the interests of the target company and in line with board members' duty of care to permit buyer due diligence in some circumstances. For example, the target company may need: an investor in a financial crisis; a high valuation for its shares; a better ownership structure; business synergies; or other benefits. Failure to permit buyer due diligence can thus amount to a breach of duty of care in some circumstances.

Exceptionally and depending on the applicable law and the company, the duty of the target's board to permit buyer due diligence can be based on a prior resolution of the general meeting or the unanimous consent of shareholders. In most cases, however, shareholders and the general meeting have very limited powers to decide on management matters.

A non-controlling shareholder typically has no power to force the target's board to permit buyer due diligence. For example, the right of a shareholder to receive financial information under the German Aktiengesetz or GmbH-Gesetz is a personal right that cannot be transferred to any prospective buyer of that shareholder's shares.

The duty of the target's board not to permit buyer due diligence. The board of the target may have a duty to refuse buyer due diligence in some cases or restrict it.

First, the exercise of the board's powers is constrained by board members' *duty of care*. Where buyer due diligence is decided on by the board, board members

should not authorise it without finding out whether it is in the interests of the company to do so.

Furthermore, it is part of board members' duty of care to ensure that the company's confidential information is adequately protected. Buyer due diligence should always be subject to restrictions and limited to certain categories of information. The use of information disclosed to the prospective buyer should be constrained by non-disclosure and no-use obligations (NDA, section 12.2).

Buyer due diligence can be restricted through the use of a data room and/or third party intermediaries. The buyer can be given an opportunity to verify certain information on the basis of documents disclosed to the buyer in the data room. Where it is not in the interests of the company to grant the buyer access to confidential information, external third party intermediaries can be used. For example, buyer due diligence can be performed by an independent auditor, and the buyer can be given an abstract report of the auditor's results. Buyer due diligence can partly be replaced by vendor due diligence.

Board members' duty of care can thus prohibit the granting of buyer due diligence where: the acquisition is in practice impossible or unlikely; the target company does not have any interest in being sold; or there is no prior NDA.

For example, the management board of a German AG must act in the interests of the company.[20] This duty also gives rise to a duty of the management board of a target company to protect the company's confidential information.[21] The management board of a target company may provide the potential buyer with confidential information only where it is in the interests of the target company to do so. The target company's interest in permitting disclosure to the potential buyer depends on the target company's interest in the acquisition.[22] The decision is made easier by the existence of a business judgment rule.[23]

Second, the *structuring* of the transaction can play a role. In an asset deal, the company itself acts as the vendor. The company may therefore have a clear incentive to permit buyer due diligence. In a share deal, the threshold for authorising a buyer due diligence can be higher. As the company typically is not party to a share deal, it has less incentive to permit buyer due diligence.

Third, where the securities of the company have been admitted to trading on a regulated market, selective disclosure is constrained by *insider rules* (Chapter 19).

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[20] § 93(1) AktG: "Die Vorstandsmitglieder haben bei ihrer Geschäftsführung die Sorgfalt eines ordentlichen und gewissenhaften Geschäftsleiters anzuwenden ..."

[21] § 93(1) AktG: "... Über vertrauliche Angaben und Geheimnisse der Gesellschaft, namentlich Betriebs- oder Geschäftsgeheimnisse, die den Vorstandsmitgliedern durch ihre Tätigkeit im Vorstand bekanntgeworden sind, haben sie Stillschweigen zu bewahren ..."

[22] For a very restrictive view, see Lutter M, Due Diligence des Erwerbers bei Kauf einer Beteiligung, ZIP 1997 pp 613 and 617. For a summary of German law in English, see Rittmeister M, The Management Board's permission to disclose Due Diligence Information Before a Corporate Acquisition in Consideration of the Impact of the Act to Improve the Protection of Investors (Gesetz zur Verbesserung des Anlegerschutzes), German L J 6(2) (February 2005).

[23] § 93(1) AktG.

The performance of due diligence can mean that the potential buyer gains access to company information which is only partly public and includes inside information. However, provisions of the Directive on market abuse do not prohibit the target's board from permitting due diligence as such.

The Market Abuse Directive prohibits a person who possesses inside information from *disclosing* inside information, but the prohibition only applies where such disclosure is not made in the normal course of the exercise of the employment, profession or duties of that person.[24] For example, the Directive does not prohibit board members from deciding to disclose inside information to a potential buyer as part of their normal board duties, or a manager from enforcing that decision as part of his own normal duties.

On the other hand, the Directive on market abuse also prohibits a person who possesses inside information from *recommending* or *inducing* another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates.[25] In share deals, permitting access to inside information by means of buyer due diligence is close to inducing the buyer to buy shares – in fact, if the board permitted buyer due diligence without any intention whatsoever to induce the buyer to buy shares, board members would typically breach their duty of care (see above).

However, it goes without saying that some forms of buyer due diligence are permitted even in share deals. The Directive on market abuse does *not* prohibit selective disclosure if the information is *not inside information*. (a) As a rule, the target should already have disclosed all inside information.[26] The information disclosed to the potential buyer is not regarded as inside information unless it "would be likely to have a significant effect" on the price of the target's shares on the price of related derivative financial instruments.[27] The data room can therefore contain other than inside information. (b) The Directive does not prohibit the (selective) disclosure of inside information if the target company simultaneously makes "complete and effective public disclosure" of that information.[28]

In any case, inside information may not be disclosed to the potential buyer without making *public disclosure* of the same information, unless the persons who gain access to the information owe a duty of *confidentiality* on the basis of an NDA or as part of their professional duties or otherwise.[29]

Fourth, the exchange of information in the course of pre-acquisition due diligence is constrained by *competition law* (see Volume I).

The exchange of information between competitors in the course of due diligence or otherwise can violate Article 81(1) of the EC Treaty which prohibits "concerted practices which may affect trade between Member States and which

[24] Article 3(a) of Directive 2003/6/EC (Directive on market abuse).
[25] Article 3(a) of Directive 2003/6/EC (Directive on market abuse).
[26] Articles 6(1) and 6(2) of Directive 2003/6/EC (Directive on market abuse).
[27] Articles 6(1) and 6(2) of Directive 2003/6/EC (Directive on market abuse).
[28] Article 1(1) of Directive 2003/6/EC (Directive on market abuse).
[29] Article 6(3) of Directive 2003/6/EC (Directive on market abuse).

have as their object or effect the prevention, restriction or distortion of competition within the common market".

The EC Merger Regulation prohibits at least some forms of "gun jumping", i.e. the implementation of the concentration prior to any clearance decision.[30] In December 2007, the Commission confirmed that it had carried out "dawn raids" under Article 13 of the EC Merger Regulation on two unnamed S PVC manufacturers in the UK on such grounds.

On the other hand, there is no prohibition of due diligence per se, as this practice does not always have a harmful purpose or effect. On the contrary, due diligence can be objectively necessary for a successful acquisition and permitted to the extent that it is necessary (non-competition clauses raise similar questions, see section 16.3 and *Remia v Commission*).[31]

In some cases, the exchange of information is not necessary. The risk is particulary high when the information relates to "purchase or selling prices or any other trading conditions" and it is made available to people responsible for such matters or sales.

The parties can therefore mitigate risk by limiting the exchange of information in the following ways:

- Buyer due diligence and the disclosure of competitively sensitive information should be delayed until the likelihood of closing increases.
- The parties should share information only if it is objectively necessary for due diligence.
- It is therefore necessary to limit the information exchanged in due diligence (data room).
- It is necessary to limit the people having access to information. Effective Chinese walls should be used.
- Only high-level executives with no day-to-day responsibility for sales and pricing decisions should have access to information.
- Purchase or selling prices or other trading conditions should only be disclosed in an aggregated form or by using averages.
- In particular, purchase or selling prices or any other trading conditions should not be disclosed in a detailed form to people responsible for sales, pricing strategy, or pricing decisions.
- Sensitive information can be disclosed to a limited due diligence team consisting of external intermediaries who analyse information, disclose the results in an aggregated form, and owe a duty of confidentiality (a "clean team" in a "clean room").
- Usually, it is less necessary for the buyer to share competitively sensitive information with the seller.

[30] Article 7(1) of Regulation 139/2004 (EC Merger Regulation).
[31] Case 42/84 Remia v Commission [1985] ECR 2545 paragraph 19.

This risk and the possible ways to mitigate it can be illustrated by the US case of *Omnicare v UnitedHealth Group*.[32]

Omnicare, a provider of pharmacy services, alleged that UnitedHealth andPacifiCare, two health insurers, had improperly shared with each other competitively sensitive prescription drug pricing data during pre-signing due diligence and post-signing merger planning and that the exchange of information constituted a "conspiracy in restraint of trade".

The court noted that "virtually no case law establishes standards for determining when premerger discussions are anticompetitive". For this reason, the decision includes a discussion of the relevant principles.

The court was hesitant to "chill business activity by companies that would merge but for a concern over potential litigation". However, the court recognised that the federal antitrust agencies have expressed concerns over improper information exchange, and that the "mere possibility of a merger cannot permit business rivals to freely exchange competitively sensitive information". To allow competitors to do so "could lead to sham merger negotiations" and "allow for periods of cartel behavior" before a merger was consummated.

In this case, the court concluded that the information exchange was "necessary to due diligence and was performed in a reasonably sensitive manner". The court took into account the fact the information was shared mostly by high-level executives evaluating the merger, and not by the personnel responsible for negotiating prescription drug agreements. Furthermore, the court was careful to distinguish between the exchange of average prices (which could be permitted) from the exchange of specific prices (which was prohibited).

The court's decision is generally consistent with guidance from the Department of Justice and Federal Trade Commission on information sharing in the context of merger negotiations between competitors.

13.3.5 Buyer Due Diligence, Buyer's Perspective

From the perspective of the buyer, the main purpose of buyer due diligence is clear. Buyer due diligence enables the buyer to gather information about return and risk. No sensible buyer would acquire a business without carrying out a detailed investigation of the target. A thorough due diligence helps the buyer in its decision as to: whether or not to proceed with the proposed transaction; what to buy; how to structure the transaction; how to draft conditions, representations, and warranties; and how much to pay for the target. [33]

Buyer due diligence is therefore much more than a way to mitigate risks caused by the *caveat emptor* ("buyer beware") principle or an exercise that helps the buyer in drafting warranties. The buyer should perform a due diligence inspection regardless of the possible existence of legal background rules that provide for the liability of the vendor of shares or assets for the characteristics of the target.

[32] Omnicare, Inc. v. UnitedHealth Group, Inc., No. 06 Civ. 06235 (N.D. III. Jan. 16, 2009). See, for example, Weil Briefing: Antitrust/Competition, District Court Examines Information Exchange By Competitors During Merger Discussions, 2 February 2009; Kühne E, Broder DF, Bei Austausch von Informationen droht Gefängnis, FAZ, 25 March 2009 p 23.

[33] See, for example, Vandrill R, Legal Due Diligence in Private Equity Transactions, Int Comp Comm L R 13(8) (2002) p 291.

However, buyer due diligence should be influenced by legal background rules. In particular, there may be rules according to which the buyer has constructive notice of certain characteristics of the target.[34]

Due diligence instead of warranties? The vendor is sometimes unwilling to provide warranties but offers the buyer an opportunity to perform a due diligence inspection instead. Should the buyer accept the vendor's offer to replace vendor's warranties with a chance to perform a due diligence inspection?

The buyer should not accept that offer. First, due diligence is necessary in any case (see above). Second, even the vendor's warranties are necessary in any case, because the buyer is not sufficiently protected without warranties and there can be things that the buyer may not notice in a due diligence inspection.

Where the buyer requires both warranties and a chance to perform due diligence, the contents of warranties and their legal relevance are influenced by due diligence.

The vendor's first draft typically contains few warranties. Furthermore, they tend to be qualified by the entire contents of the vendor's data room, and diluted by: high materiality thresholds; restrictions on the liability of the vendor for breach of warranty (caps such as reduction of purchase price up to a certain maximum amount or percentage of purchase price); and time bars for claiming breaches of warranty that expire upon completion of the acquisition.[35]

In principle, the buyer can seek multiple detailed warranties on various items. In practice, this would make negotiations more complicated and increase transaction costs.

The parties can therefore try to simplify negotiations in various ways. If the parties use detailed warranties, they will often be qualified by information "fairly disclosed" (section 16.2) in the data room. If the parties agree on broadly formulated warranties, the warranties will be complemented by specific detailed warranties limited to areas of concern identified in due diligence. Some buyers can take out a warranty insurance and transfer part of the risk to a third party (section 16.4).[36]

Warranties instead of due diligence? In some cases, the vendor might refuse to permit a sufficient buyer due diligence. Instead, the vendor might offer warranties. Should the buyer accept the vendor's offer to substitute warranties for a chance to perform a sufficient due diligence inspection?

The buyer should not accept that offer either. The warranties of the vendor would not be a sufficient way to protect the buyer. In the absence of a sufficient due diligence inspection, the buyer would be exposed to a high commercial risk and counterparty commercial risk. The buyer would simply buy a "pig in the bag". For many reasons, this would be unacceptable. It is difficult both de facto and de jure to rescind a business acquisition contract (see below). It can be time-

[34] See CISG Article 36(1), CISG Article 35(3), and CISG Article 39(1). For German law, see nevertheless § 442(1) BGB.

[35] Schmidt KM, Private Equity: Current M&A Issues for Buyers. In: PLI, Eighth Annual Private Equity Forum, Corporate Law and Practice Course Handbook Series (2007).

[36] *Ibid.*

consuming and expensive to enforce breach of warranty claims. Even if the buyer succeeded in obtaining a favourable judgment, it would be unclear whether the vendor had the financial means to reimburse the buyer for all damage that it has sustained. In addition, most breach of warranty claims are subject to time limits[37] and financial thresholds.

The right of the buyer to ask for information. The buyer is not prevented from asking the target for permission to perform a due diligence inspection.

The right of the buyer to receive information. Whether the buyer is entitled to perform a due diligence inspection or entitled to receive information otherwise is another matter. It is important to distinguish between information to be disclosed by the vendor and information to be disclosed by the target.

First, the vendor may have a duty to disclose information to the buyer before closing. The parties may agree on such a pre-contractual right when they reach a preliminary understanding (letter of intent) or sign a contract document before closing. The buyer is also protected by the fraud rule.

Second, the vendor may have a duty to disclose certain facts to the buyer before closing according to a substantive rule or an information rule which is a substantive rule in disguise. This can influence the interpretation of the contract. If the vendor does not disclose such facts, the vendor risks breach of contract.

Third, the target can have a duty to disclose information to the public. This applies, in particular, to financial information (Volume I).

The duty of the buyer to ask for information. Generally, the buyer has no legal duty to ask for information. However, failure to perform a due diligence information search properly when given permission to do so can have an adverse effect on the rights of the buyer to invoke breach of contract depending on the governing law and the contract.[38] For example, the prospective acquirer might be regarded to have waived its right to invoke things that it could have noticed had it performed the due diligence inspection after being given an opportunity to do so. Furthermore, the buyer's board members have information-related duties.

13.3.6 Buyer Due Diligence, Buyer's Board

It would be contrary to board members' duty of care to authorise an acquisition without a sufficient information basis.[39] Due diligence assists the board in making an informed judgment. It makes it easier to prepare disclosure documents and acts as a liability mitigation device.[40]

There are several legal constraints on the use of information obtained from the target or the vendor.

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[37] See, for example, CISG Article 39(1).
[38] See CISG Articles 36(1), 35(3), and 39(1). For German law, see nevertheless § 442(1) BGB.
[39] For German law, see the case LG Hannover, AG 1977 pp 198 and 200–201.
[40] See Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 177–179.

Before permitting buyer due diligence, the target may, for legal reasons, have required members of the buyer's board to undertake non-disclosure obligations (NDA). Contractual undertakings may have been necessary for a combination of reasons: members of the buyer's board do not owe any general duty of confidentiality to the target company;[41] disclosure of inside information to a person who does not owe a duty of confidentiality to the issuer triggers a duty to make the same information public; and stock exhange rules can require project-specific insider lists.

In addition to insider rules (Chapter 19),[42] there can be other provisions of law that prevent members of the buyer's board from using information obtained in the course of buyer due diligence. For example, they may have a personal duty not to use information if it has been obtained unlawfully.

13.4 Particular Remarks on External Fairness Opinions

In the EU, both parties often supply fairness opinions from an investment bank as part of the due diligence process. Fairness opinions are typical where the transaction must be authorised by the general meeting (for mergers, see section 5.11.7). The board will submit the fairness opinion to the general meeting.

Purpose. The stated purpose of fairness opinions may be to ensure that the transaction is fair to shareholders from a financial point of view. In addition, their typical hidden purpose is to: make the proposed transaction look favourable; signal to shareholders that they should vote for the transaction or accept the offer; and to mitigate the risk of board members' liability for breach of duty. The board may also submit other opinions by independent advisers.

How fair are external fairness opinions? External fairness opinions are not always "fair". Typically, investment banks have significant discretion in arriving at a "fair" price. They do not have incentives to provide an accurate valuation and might have incentives to provide a fairness opinion supporting the position of the party inviting the opinion.[43] At best, fairness opinions offer a view as to whether the transaction as a whole and the consideration offered in the transaction are within the range of what would be considered "fair", rather than offering an opinion as to whether the transaction and the consideration offered are the best that could likely be attained.

Regulation. The submission of a fairness opinion or the substance of other independent advice can be mandatory under the applicable securities markets laws. In the absence of a mandatory rule, it may be part of commercial practice. Typically, a fairness opinion can also be considered by the court as evidence that board members tried to make a well-informed decision based on objective advice.

[41] See Article 6(3) of Directive 2003/6/EC (Directive on market abuse).

[42] Article 2(1) of Directive 2003/6/EC (Directive on market abuse).

[43] Generally, see Bebchuk LA, Kahan M, Fairness Opinions: How Fair Are They and What Can Be Done About It? Duke L J 1989 (Symposium: Fundamental Corporate Changes: Causes, Effects and Legal Responses) pp 27–53.

As explained in Volume I, third parties such as shareholders to whom the fairness opinion is passed can hardly ever make the provider of the fairness opinions liable.

Community law. Fairness opinions are typical in acquisitions. Some external opinions are required under EU company law directives and implementing legislation in: companies that participate in a merger (section 5.11.7); companies thar participate in a division (section 10.4.4); and companies that issue shares for a consideration other than in cash (section 5.11.2).[44] Whereas such statutory opinions can be functional equivalents to "fairness opinions" in market practice, particular fairness opinions typically are not regarded as opinions required by the law, as the latter must fulfil the statutory requirements.

EU securities markets law does not require the publication of external fairness opinions or independent advice. For example, the Directive on takeover bids only requires the publication of an offer document which reflects the opinion of the offeror's board,[45] and the opinion of the offeree's board.[46]

Member States' laws. Fairness opinions can be required by the provisions of Member States' national laws in the context of public bids[47] or otherwise. In some countries, the publication of fairness opinions or independent advice is mandatory. For example in England, Rule 3 of the City Code on Takeovers and Mergers (Takeover Code) requires the board of the offeree company to obtain "competent independent advice" on any offer and to make the substance of such advice known to the company's shareholders (Rule 3.1). Sometimes the board of the offeror company has a similar duty (Rule 3.2). In France, Chapters I and II of Title VI (Book II) of the General Regulation of the Autorité des marches financiers (AMF) provides for independent appraisers and appraisals.

In many countries, external fairness opinions or the publication of independent advice may be part of commercial practice, a way to signal the benefits of the board's proposal to shareholders, and a way to mitigate board members' personal liability.

US law. In the US, fairness opinions are routinely obtained by the boards of directors in corporate control transactions and address the fairness, from a financial perspective, of the consideration being offered in the transaction. They were effectively required in the Delaware case of *Smith v. Van Gorkom*.

The use of fairness opinions in deals has come under increased scrutiny. The judgment of Delaware Court of Chancery in *TCI* shows that there may be circumstances where a fairness opinion given pursuant to a contingent fee arrangement will not be considered independent.[48]

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[44] See, in particular, Article 27 of Directive 77/91/EEC (Second Company Law Directive) and Article 10 of Directive 78/855/EEC (Third Company Law Directive).

[45] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).

[46] Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).

[47] Article 3(2) of Directive 2004/25/EC (Directive on takeover bids).

[48] See Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice.New York City (2008) pp 63–66.

In October 2007, the SEC approved Rule 2290, requiring specific disclosures in fairness opinions provided by investment banks. The new Rule's requirements include the disclosure by the investment bank of significant compensation that is contingent on the successful completion of the transaction.

Rule 2290 attempts to address concerns regarding the conflict of interest that exists when an investment bank provides advisory services on a deal, generally with significant compensation tied to the deal's closing, and also opines that the deal is fair. However, Rule 2290 does not require a truly independent opinion. For an opinion free of conflicts of interest, companies will have to turn to independent firms that do not have a vested interest in the consummation of the transaction.

14 Excursion: Merger Control

14.1 General Remarks

Merger control and competition law in general belong to things that lawyers will focus on in legal due diligence. It is therefore useful to have a look at the effects of European merger control on acquisitions.

Economic efficiency. To begin with, acquisitions can increase efficiency. For example, combining the activities of two firms can allow them to develop new products more efficiently or to reduce production or distribution costs through economies of scale. In principle, this might make the market more competitive and enable consumers to benefit from higher-quality goods at fairer prices.

On the other hand, some acquisitions may reduce competition in a market. For example, they might create or strengthen a dominant player. This could harm customers and consumers through higher prices, reduced choice, or less innovation.

For such reasons, merger control is an important concern in large business acquisitions. In the EU, acquisitions can be constrained either by EU merger control or national merger control. EU merger control is based on the competition law provisions of the EC Treaty (Articles 81 and 82) and the EC Merger Regulation.[1]

Article 81, early days. Article 81(1) of the EC Treaty prohibits agreements, decisions and concerted practices between two or more firms which restrict competition. Such things are nowadays prohibited automatically without any prior decision by the competent authorities being necessary.[2]

As individually negotiated business acquisitions are based on agreements, it seems clear that Article 81 could be applied to business acquisitions. In the early days of the EEC, however, the Commission believed that concentrations helped firms to grow, take advantage of the common market, and meet competition from large enterprises outside the EEC. In other words, they were regarded as a good thing. In a 1966 memorandum, the Commission said that "[i]t is not possible to apply Article [81] to agreements whose purpose is the acquisition of total or partial ownership of enterprises or the reorganisation of the ownership of enterprises (merger, acquisition of holding, purchase of part of the assets."[3]

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1 Regulation 139/2004 on the control of concentrations between undertakings (the EC Merger Regulation).

2 Article 1(1) of Regulation 1/2003.

3 Memorandum on the Concentration of Enterprises in the Common Market. Study No. 3 (Brussels 1966).

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
DOI 10.1007/ 978-3-642-03058-1_14, © Springer-Verlag Berlin Heidelberg 2010

Article 82, market abuse. Article 82 of the EC Treaty prohibits the abuse of a dominant position without any prior decision by the competent authorities being necessary.[4] In *Continental Can*, the ECJ decided that Article 82 could be applied to corporate acquisitions. According to the ECJ, Article 82 could be applied where a previously dominant undertaking "strengthens its dominant position in such a way that the degree of dominance reached substantially fetters competition, i.e. that only undertakings remain in the market whose behaviour depends on the dominant one".[5] In *Hoffmann-La Roche*, the ECJ no more required the condition laid down in Continental Can that any reduction of competition resulting from the allegedly abusive conduct should be substantial.

The ECJ said: "The concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which is such a to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition."[6]

Article 81, competitors, wider application. Although Article 82 could be applied to business acquisitions, it was still unclear whether Article 81 could be applied to them. This was clarified in the *Philip Morris/Rothmans* case in which the ECJ held that, in principle, an agreement whereby one company acquires a shareholding in a competitor can fall within Article 81 where it is shown that the acquisition of such a shareholding can have the effect of restricting competition.

The ECJ said: "Although the acquisition by one company of an equity interest in a competitor does not itself constitute conduct restricting competition, such an acquisition may nevertheless serve as an instrument for influencing the commercial conduct of the companies in question so as to restrict or distort competition on the market on which they carry on business."[7] The ECJ continued: "That will be true in particular where, by the acquisition of a shareholding or through subsidiary clauses in the agreement, the investing company obtains legal or de facto control of the commercial conduct of the other company or where the agreement provides for commercial cooperation between the companies or creates a structure likely to be used for such cooperation."[8]

The *Philip Morris/Rothmans* case opened the door to a wider application of Article 81 in this area and contributed to the adoption of the first EC Merger Control

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[4] Article 1(3) of Regulation 1/2003.
[5] Case 6/72 Europemballage Corporation and Continental Can Company v Commission [1973] ECR 215, paragraph 26.
[6] Case 85/76 Hoffmann-La Roche v Commission [1979] ECR 461, paragraph 91.
[7] Joined Cases 142 and 156/84 British-American Tobacco Company Ltd and R. J. Reynolds Industries Inc. v Commission [1987] ECR 4487, paragraph 37.
[8] *Ibid*, paragraph 38.

Regulation in 1989.[9] After being substantially amended, the Regulation was recast in 2004.[10]

EC Merger Regulation. The EC Merger Regulation applies to the control of concentrations[11] between undertakings and is based on the "one-stop shop" principle.

The Commission has adopted a set of guidelines to explain its current practice.[12] It is to be noted that there can be differences between the US approach and the European approach, although the gap is getting narrower.[13] For example, in 2001, the Commission blocked the merger of *General Electric* and *Honeywell*, which US regulators had waved through.[14]

Community dimension. A two-fold test defines the operations to which the EC Merger Regulation applies. The first test is that the operation must be a "concentration".[15] The second comprises turnover thresholds designed to identify those operations which have an impact upon the Community and can be deemed to be of "Community dimension".[16] Turnover is used as a proxy for the economic resources being combined in a concentration, and is allocated geographically in order to reflect the geographic distribution of those resources.[17]

14.2 Jurisdiction

The parallel application of EC merger control law and the competition laws of one or more Member States would make mergers and takeovers complicated. The Regulation provides for division of labour between the Commission and the Member States.

One-stop shop. The provisions of the EC Merger Regulation create a "one-stop shop" system in compliance with the principle of subsidiarity. (a) The Regulation applies to significant structural changes, the impact of which on the market goes beyond the national borders of any one Member State. As a general rule, such concentrations should be reviewed exclusively at Community level. (b) Concentrations not covered by the Regulation should come within the jurisdiction of the Member States.

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[9] Regulation 4064/89 on the control of concentrations between undertakings.

[10] For the legal basis of the Regulation, see recital 7 of Regulation 139/2004 (EC Merger Regulation).

[11] Article 3(1) of Regulation 139/2004 (EC Merger Regulation).

[12] Commission Consolidated Jurisdictional Notice under Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings, OJ C 095, 16.04.2008 pp 1–48.

[13] See, for example, Mergers and dominant firms, The Economist, May 2008.

[14] Commission Decision 2004/134/EC in Case No COMP/M.2220 – General Electric/Honeywell, OJ 2004 L 48 p 1.

[15] Article 3 of Regulation 139/2004 (EC Merger Regulation).

[16] Article 1 of Regulation 139/2004 (EC Merger Regulation).

[17] See Commission Consolidated Jurisdictional Notice, paragraph 124.

Jurisdiction of the Commission. The Commission has exclusive competence to apply the EC Merger Regulation, subject to review by the ECJ.[18] All mergers having a Community dimension will therefore be examined by the Commission.

In some cases, one or more Member States may request the Commission to examine a concentration that does *not* have a Community dimension. They have such a right where the concentration affects trade between Member States and threatens to significantly affect competition within the territory of the Member State or States making the request.[19]

Jurisdiction of national competition authorities. The jurisdiction of Member States' competent authorities is determined by three main rules.

First, Member States' competent authorities are permitted to apply their national legislation on competition to concentrations that do not have a Community dimension. If the concentration is not regarded as one with a Community dimension, it may qualify for examination under a number of national merger control systems. Multiple notification of the same transaction increases legal uncertainty, effort and cost for undertakings and may lead to conflicting assessments.[20]

Second, Member States' competent authorities are not permitted to apply their national legislation on competition to concentrations with a Community dimension. There are some exceptions. Under certain circumstances, the Commission may decide to refer a notified concentration to the competent authorities of a Member State.[21] Furthermore, Member States may have a right to protect legitimate interests other than those pursued by the Regulation, provided that such measures are compatible with the general principles and other provisions of Community law.[22]

Third, the Member States are not permitted to apply the EC Merger Regulation.

Community dimension. The jurisdiction of national competition authorities or the Commission depends to a large extent on whether the concentration has Community dimension or not. If the annual turnover of the combined businesses exceeds specified thresholds in terms of global and European sales, the proposed merger must be notified to the European Commission. Below these thresholds, national competition authorities may review the merger.

Two sets of thresholds are set out in Article 1 to establish whether the operation has a Community dimension.

First, Article 1(2) establishes three different criteria: the worldwide turnover threshold is intended to measure the overall dimension of the undertakings concerned; the Community turnover threshold seek to determine whether the concentration involves a minimum level of activities in the Community; and the two-

[18] Recital 17 of Regulation 139/2004 (EC Merger Regulation).

[19] Article 22(1) of Regulation 139/2004 (EC Merger Regulation).

[20] Recital 12 of Regulation 139/2004 (EC Merger Regulation).

[21] Article 9 of Regulation 139/2004 (EC Merger Regulation).

[22] Article 296 of the EC Treaty. See recital 19 of Regulation 139/2004 (EC Merger Regulation).

thirds rule aims to exclude purely domestic transactions from Community jurisdiction.[23]

A concentration thus has a Community dimension where: (a) the combined aggregate worldwide turnover of all the undertakings concerned is more than €5 billion; and (b) the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than €250 million. However, the concentration does not have a Community dimension where each of the undertakings concerned achieves more than two-thirds of its aggregate Community-wide turnover within one and the same Member State.[24]

Second, Article 1(3) contains another set of thresholds designed to tackle those concentrations which fall short of achieving Community dimension under Article 1(2), but would have a substantial impact in at least three Member States leading to multiple notifications under national competition rules of those Member States. For this purpose, Article 1(3) lays down lower turnover thresholds.[25]

A concentration can thus have a Community dimension even where the concentration does not meet the normal thresholds. A concentration that does not meet those thresholds has a Community dimension where: (a) the combined aggregate worldwide turnover of all the undertakings concerned is more than €2.5 billion; (b) in each of at least three Member States, the combined aggregate turnover of all the undertakings concerned is more than €100 million; (c) in each of at least three Member States included for the purpose of point (b), the aggregate turnover of each of at least two of the undertakings concerned is more than €25 million; and (d) the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than €100 million. However, the concentration does not have a Community dimension where each of the undertakings concerned achieves more than two-thirds of its aggregate Community-wide turnover within one and the same Member State. [26]

On the other hand, there are some exceptions to this rule. First, the Commission may also examine mergers which are referred to it from Member States' national competition authorities. Second, under certain circumstances, the Commission may also refer a case to a Member State's national competition authority.[27]

Extraterritorial scope. Community dimension is also influenced by the extraterritorial scope of the EC Merger Regulation.

In principle, the international scope of Community competition law is restricted by the principle of territoriality, a general principle of public international law which the Community must observe in the exercise of its powers.[28] However, the ECJ has interpreted territoriality widely and applied the effects doctrine, also

[23] Commission Consolidated Jurisdictional Notice, paragraph 125.
[24] Article 1(2) of Regulation 139/2004 (EC Merger Regulation).
[25] Commission Consolidated Jurisdictional Notice, paragraph 126.
[26] Article 1(3) of Regulation 139/2004 (EC Merger Regulation).
[27] See recital 15 of Regulation 139/2004 (EC Merger Regulation).
[28] Joined Cases 89/85, 104/85, 114/85, 116/85, 117/85 and 125/85 to 129/85 Ahlström and others v Commission [1988] ECR 5193, paragraph 18 (the Wood pulp case); Case C-286/90 Poulsen and Diva Corp. [1992] ECR I-6019, paragraph 9.

known as as the principle of objective territoriality. An undertaking that does business in the Community will have to comply with EU merger law.

This can be illustrated by the case of *Gencor*.[29] A South African company (Gencor Ltd) and an English company (Lonrho Plc) proposed to acquire joint control of a South African company (Impala Platinum Holdings Ltd, Implats). In the second stage, that South African company (Implats) was to be granted sole control of two South African companies (Eastern Platinum Ltd and Western Platinum Ltd, generally known under the name of Lonrho Platinum Division). In this case, the mining and production activities of the participating undertakings were mainly located in Africa. According to the ECJ, the Merger Control Regulation did not require that, in order for a concentration to be regarded as having a Community dimension, the undertakings in question must be established in the Community or that the production activities covered by the concentration must be carried out within Community territory.[30] The ECJ said that neither the provisions of the EC Treaty nor those of the Merger Control Regulation excluded from the Regulation's field of application "concentrations which, while relating to mining and/or production activities outside the Community, have the effect of creating or strengthening a dominant position as a result of which effective competition in the common market is significantly impeded".[31] The ECJ also said that Gencor and Lonrho each carried out significant sales in the Community.[32] As a result, the proposed transactions fell within the scope of EU merger law and was appraised under the EC Merger Regulation.

The merger of *Boeing* and *McDonnell Douglas* was one of the first non-European mergers considered by the Commission. The US Federal Trade Commission (FTC) had had jurisdiction over the merger and it had approved the merger without conditions on 1 July 1997 after a six-month investigation. The threat of a ban of the merger by the European Commission under Community merger law was not perceived as credible at first. However, had the companies proceeded without the approval of the European Commission, they would have potentially faced large fines and potential harm to their customers. Had they chosen to delay the merger, the resulting uncertainty would have potentially damaged their customers, suppliers, employees, and shareholders. Boeing decided to bow to pressure. As a condition of clearance by the Commission, Boeing agreed to certain conditions to address Commission concerns regarding the merger (see below).

14.3 Complying with Community Law

The EC Merger Regulation applies to all concentrations with a Community dimension.[33] This raises many questions. What does a concentration mean? What do the parties have to do when they are proposing a concentration? What concentrations are compatible with Community law? What conditions can the Commission require? What are the sanctions for non-compliance?

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[29] Case T-102/96 Gencor v Commission [1999] ECR II-753.

[30] Case T-102/96 Gencor v Commission [1999] ECR II-753 paragraph 79. See also recital 10 of Regulation 139/2004 (EC Merger Regulation).

[31] Case T-102/96 Gencor v Commission [1999] ECR II-753 paragraph 82.

[32] Case T-102/96 Gencor v Commission [1999] ECR II-753 paragraph 85.

[33] Article 1(1) of Regulation 139/2004 (EC Merger Regulation).

Concentration. A concentration has been defined as follows: "A concentration shall be deemed to arise where a change of control on a lasting basis results from: (a) the merger of two or more previously independent undertakings or parts of undertakings, or (b) the acquisition, by one or more persons already controlling at least one undertaking, or by one or more undertakings, whether by purchase of securities or assets, by contract or by any other means, of direct or indirect control of the whole or parts of one or more other undertakings."[34] In addition, the creation of a joint venture performing on a lasting basis all the functions of an autonomous economic entity constitutes a concentration.[35]

A concentration thus only covers operations where a change of control in the undertakings concerned occurs on a lasting basis. The concept of concentration is intended to relate to operations which bring about a lasting change in the structure of the market.[36] The existence of a concentration is to a great extent determined by qualitative rather than quantitative criteria.[37]

Control. Control is defined by the EC Merger Regulation as the possibility of exercising decisive influence on an undertaking. It is therefore not necessary to show that the decisive influence is or will be actually exercised. A concentration may occur on a legal or a de facto basis, may take the form of sole or joint control, and extend to the whole or parts of one or more undertakings.[38]

For example, sole control is acquired if one undertaking alone can exercise decisive influence on an undertaking. Sole control can be acquired in two main ways. First, the solely controlling undertaking enjoys the power to determine the strategic commercial decisions of the other undertaking. This power is typically achieved by the acquisition of a majority of voting rights in a company. Second, so-called negative sole control exists where only one shareholder is able to veto strategic decisions in an undertaking, but this shareholder does not have the power, on his own, to impose such decisions. Since this shareholder can produce a deadlock situation, the shareholder acquires decisive influence and therefore control within the meaning of the EC Merger Regulation.[39]

Joint control. As stated above, the acquisition of control may be in the form of sole or joint control. Joint control exists where two or more undertakings or persons have the possibility of exercising decisive influence over another undertaking. In order for joint control to exist, those shareholders must have reached a common understanding in determining the commercial policy of the controlled undertaking and they must cooperate. As in the case of sole control, the acquisition of joint control can also be established on a de jure or de facto basis.[40]

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[34] Article 3(1) of Regulation 139/2004 (EC Merger Regulation).
[35] Article 3(4) of Regulation 139/2004 (EC Merger Regulation).
[36] Recital 20 of Regulation 139/2004 (EC Merger Regulation).
[37] Commission Consolidated Jurisdictional Notice, paragraph 7.
[38] Article 3(2) of Regulation 139/2004 (EC Merger Regulation); Commission Consolidated Jurisdictional Notice, paragraph 16.
[39] Commission Consolidated Jurisdictional Notice, paragraph 54.
[40] Commission Consolidated Jurisdictional Notice, paragraphs 62 and 63.

Merger. A merger within the meaning of the Merger Regulation occurs when two or more independent undertakings amalgamate into a new undertaking and cease to exist as separate legal entities. A merger may also occur when an undertaking is absorbed by another, the latter retaining its legal identity while the former ceases to exist as a legal entity. A merger within the meaning of the Merger Regulation may also occur where, in the absence of a legal merger, the combining of the activities of previously independent undertakings results in the creation of a single economic unit.[41]

Notification. The EC Merger Regulation lays down a duty to notify concentrations to the Commission if they have a Community dimension. They must be notified to the Commission prior to their implementation.

Notification must be made following the conclusion of the agreement, the announcement of the public bid, or the acquisition of a controlling interest.

Notification may also be made where the undertakings concerned demonstrate to the Commission a good faith intention to conclude an agreement or, in the case of a public bid, where they have publicly announced an intention to make such a bid, provided that the intended agreement or bid would result in a concentration with a Community dimension.[42] For example, notification is possible on the basis of an agreement in principle, a memorandum of understanding, or a letter of intent signed by all undertakings concerned.[43]

Suspension of implementation. The implementation of concentrations must be suspended until a final decision of the Commission has been taken.[44]

The Commission may nevertheless grant a derogation.[45] In deciding whether or not to grant a derogation, the Commission will take account of all pertinent factors, such as the nature and gravity of damage to the undertakings concerned or to third parties, and the threat to competition posed by the concentration.[46]

There is a special rule on public takeover bids. The rule on suspension of implementation does not prevent the implementation of a public bid, provided that: (a) the concentration is notified to the Commission without delay; and (b) the acquirer does not exercise the voting rights attached to the securities in question or does so only to maintain the full value of its investments based on a derogation granted by the Commission.[47]

Compatibility with Community law. The compatibility of a concentration with Community law depends on Articles 81 and 82 of the EC Treaty. The Commission may not permit any derogation from Article 82. A derogation is possible from Article 81(1) under certain circumstances mentioned in Article 81(3). Generally, the EC Merger Regulation is without prejudice to Articles 81 and 82 of the Treaty.

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[41] Commission Consolidated Jurisdictional Notice, paragraphs 9 and 10.
[42] Article 4(1) of Regulation 139/2004 (EC Merger Regulation).
[43] Recital 34 of Regulation 139/2004 (EC Merger Regulation).
[44] Article 7(1) of Regulation 139/2004 (EC Merger Regulation).
[45] Article 7(3) of Regulation 139/2004 (EC Merger Regulation).
[46] Recital 34 of Regulation 139/2004 (EC Merger Regulation).
[47] Article 7(2) of Regulation 139/2004 (EC Merger Regulation).

The EC Merger Regulation contains two main rules on the assessment of concentrations.

First, a concentration which would *not* significantly impede effective competition in the common market or in a substantial part of it must be declared *compatible* with the common market.[48] This may be, for example, where the market share of the undertakings concerned does not exceed 25% either in the common market or in a substantial part of it.[49]

Second, a concentration which *would* significantly impede effective competition in the common market or in a substantial part of it must be declared *incompatible* with the common market.[50] This is especially the case where the significant impediment to effective competition is a result of the creation or strengthening of a dominant position. On the other hand, the notion of “significant impediment to effective competition” extends beyond the concept of dominance. For example, many oligopolistic markets exhibit a healthy degree of competition. In such markets, the notion of “significant impediment to effective competition” can cover, say, the anti-competitive effects of a concentration resulting from the non-coordinated behaviour of undertakings which would not have a dominant position.[51]

In addition to those two main rules, the EC Merger Regulation sets out what the Commission must take into account when establishing whether or not a concentration is compatible with the common market.[52] For example, the Commission may take account of any substantiated and likely efficiencies that counteract the effects on competition, and the potential harm to consumers.[53]

The EC Merger Regulation also sets out how the Commission must decide: Where the Commission concludes that the concentration notified does not fall within the scope of the Regulation, it must record that finding by means of a decision.[54] Where the Commission finds that the concentration notified, although falling within the scope of this Regulation, does not raise serious doubts as to its compatibility with the common market, the Commission must declare that it is compatible with the common market.[55] Where the Commission finds that the concentration notified falls within the scope of this Regulation and raises serious doubts as to its compatibility with the common market, it must decide to initiate proceedings.[56]

If the Commission has initiated proceedings, it may decide to: (1) declare the concentration compatible with the common market;[57] (2) declare the concentration compatible with the common market following modification by the undertakings

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[48] Article 2(2) of Regulation 139/2004 (EC Merger Regulation).
[49] Recital 32 of Regulation 139/2004 (EC Merger Regulation).
[50] Recital 2(3) of Regulation 139/2004 (EC Merger Regulation).
[51] Recital 25 of Regulation 139/2004 (EC Merger Regulation).
[52] Article 2(1) of Regulation 139/2004 (EC Merger Regulation).
[53] Recital 29 of Regulation 139/2004 (EC Merger Regulation).
[54] Article 6(1)(a) of Regulation 139/2004 (EC Merger Regulation).
[55] Article 6(1)(b) of Regulation 139/2004 (EC Merger Regulation).
[56] Article 6(1)(c) of Regulation 139/2004 (EC Merger Regulation).
[57] Article 8(1) of Regulation 139/2004 (EC Merger Regulation).

concerned and, possibly, attach to its decision conditions and obligations;[58] or (3) declare that the concentration is incompatible with the common market.[59]

Conditions and commitments. It is normal to modify a notified concentration by offering commitments with a view to rendering the concentration compatible with the common market. The Commission may attach to its decision conditions and obligations intended to ensure that the undertakings comply with the commitments.[60] Such commitments should be proportionate to the competition problem and entirely eliminate it.[61]

In the *Boeing/McDonnel Douglas* case, for example, the Commission had several concerns such as the potential spillover of benefits from the McDonnell Douglas defense business to the Boeing commercial airplane business, the market share of Boeing, and the existence of exclusive supplier agreements with commercial aircraft purchasers. Because of the Commission's concerns, Boeing agreed, among other things: to license patents obtained under US government-funded contracts to commercial aircraft manufacturers on a non-exclusive, reasonable-royalty basis; not to leverage customer support provided for existing McDonnell Douglas commercial aircraft to obtain any advantage in sales of new commercial aircraft; not to enter into any new "exclusive" supplier agreements with commercial aircraft purchasers until 1 August 2007, except where another aircraft manufacturer has offered such an agreement; and not to enforce the exclusivity provisions in its existing agreements with certain US airlines.

Another example of the use of conditions is the *takeover of BOC by Linde*. In July 2006, the European Commission approved the acquisition of BOC, a British company, by Linde, a German company. Both companies were active in the market for industrial and specialty gases. The clearance was conditional upon the following commitments: (i) the divestiture of Linde's industrial gas business in Britain; (ii) the divestiture of BOC's industrial and specialty gas business in Poland; (iii) cutting BOC's structural links with French Air Liquide in a number of Asian joint ventures; and (iv) divesting several helium wholesale supply contracts of both Linde and BOC.

Some conditions are core conditions without which the concentration would be deemed to significantly impede effective competition or without which the criteria for derogating from Article 81(1) of the EC Treaty would not be possible. Breach of such conditions can carry heavier sanctions.[62] If the concentration is implemented, it is treated in the same way as a non-notified concentration implemented without authorisation. Where the Commission has already found that, in the absence of the condition, the concentration would be incompatible with the common market, it can directly order the dissolution of the concentration, so as to restore the situation prevailing prior to the implementation of the concentration.[63]

Sanctions for non-compliance. The EC Merger Regulation provides for sanctions for non-compliance. Some of them apply to breach of a condition. Others

[58] Article 8(2) of Regulation 139/2004 (EC Merger Regulation).
[59] Article 8(3) of Regulation 139/2004 (EC Merger Regulation).
[60] Article 6(2) of Regulation 139/2004 (EC Merger Regulation).
[61] Recital 30 of Regulation 139/2004 (EC Merger Regulation).
[62] Article 8(4) of Regulation 139/2004 (EC Merger Regulation).
[63] Article 8(4) of Regulation 139/2004 (EC Merger Regulation). See also recital 31.

apply to concentrations that have already been implemented although they have been declared incompatible with the common market.

The Commission may revoke its earlier decision to declare the concentration compatible with the common market where: the declaration of compatibility was based on incorrect information for which one of the undertakings is responsible or where it was obtained by deceit; or the undertakings concerned commit a breach of an obligation attached to the decision.[64]

Where the concentration has already been implemented and it has been declared incompatible with the common market, the Commission may order any appropriate measure to ensure that the undertakings concerned dissolve the concentration or take other restorative measures.[65] The same applies to breaches of core conditions.[66]

The Commission may also take interim measures appropriate to restore or maintain conditions of effective competition under certain circumstances.[67]

The Commission may impose periodic penalty payments not exceeding 5% of the average daily aggregate turnover of the undertaking or undertakings in order to compel them to comply with: an obligation imposed by a Commission decision;[68] or any restorative measures ordered by Commission decision.[69]

There are special rules protecting the validity of transactions in securities admitted to trading on a stock exchange.[70]

Inspections. The Commission has wide powers of inspection. The Commission may conduct "all necessary inspections of undertakings and associations of undertakings" in order to carry out the duties assigned to it by the Regulation.[71] At the request of the Commission, the competent authorities of the Member States shall undertake the inspections which the Commission considers to be necessary.[72]

The supplying of incorrect or misleading information to the Commission carries a fine. The maximum amount of the fine is 1% of the aggregate turnover of the undertaking or undertakings concerned.[73] When complying with decisions of the Commission, the undertakings and persons concerned cannot be forced to admit that they have committed infringements, but they are in any event obliged to answer factual questions and to provide documents, even if this information may

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64 Article 6(6) of Regulation 139/2004 (EC Merger Regulation).
65 Article 8(4) of Regulation 139/2004 (EC Merger Regulation).
66 Article 8(4) of Regulation 139/2004 (EC Merger Regulation).
67 Article 8(5) of Regulation 139/2004 (EC Merger Regulation).
68 Article 15(1) of Regulation 139/2004 (EC Merger Regulation). See also Articles 6(1)(b), 7(3), and 8(2), second subparagraph.
69 See Articles 8(4) and 8(5) of Regulation 139/2004 (EC Merger Regulation).
70 Articles 7(2) and 7(4) of Regulation 139/2004 (EC Merger Regulation). See also recital 34: "… In the interest of legal certainty, the validity of transactions must nevertheless be protected as much as necessary."
71 Article 13 of Regulation 139/2004 (EC Merger Regulation).
72 Article 12(1) of Regulation 139/2004 (EC Merger Regulation).
73 Article 14 of Regulation 139/2004 (EC Merger Regulation).

be used to establish against themselves or against others the existence of such infringements.[74]

The Commission may also impose periodic penalty payments not exceeding 5% of the average daily aggregate turnover for failure to supply complete and correct information or to submit to an inspection.[75]

The ECJ may review decisions whereby the Commission has fixed a fine or periodic penalty payments.[76]

When the Commission gets it wrong. In principle, the Community can be liable where the Commission has committed "a breach of a rule of law intended to confer rights on individuals that was sufficiently serious to give rise to liability on the Community's part". In the case of *MyTravel*, there was no liability although the Court lifted the prohibition of a takeover.[77]

14.4 National Merger Control

National merger control can be applied to concentrations that do not have Community dimension. The quantitative thresholds laid down by the EC Merger Regulation are complemented by the "two-thirds" rule.[78] It prevents the attribution of a Community dimension to large concentrations where two-thirds of the parties' respective turnovers are made in one and the same Member State. Such concentrations fall within the competence of the relevant national competence authority and not the European Commission. National merger control falls outside the scope of this book.

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[74] Recital 41 of Regulation 139/2004 (EC Merger Regulation).
[75] Article 15(1) of Regulation 139/2004 (EC Merger Regulation).
[76] Article 16 of Regulation 139/2004 (EC Merger Regulation).
[77] T-212/03 MyTravel v Commission, paragraph 132.
[78] Article 1(3) of Regulation 139/2004 (EC Merger Regulation).

15 Excursion: Sovereign Wealth Funds

15.1 General Remarks

Sovereign wealth funds, foreign state-owned monopolies, and the national champions of other countries have emerged as an important group of buyers in the takeover market. This has increased regulatory concerns in the targets' home countries and made governments more cautious than before.

There are many examples of this phenomenom. Sovereign wealth funds originating from China and the Persian Gulf have invested in various industries worldwide in order to place their huge currency reserves. Russian monopolies have been used as a foreign policy tool, particularly in Europe. In 2006, France blocked the attempt of Enel, the largest power company in Italy, to take over Suez, the French energy champion, and Spain blocked the bid of E.ON, a very large Germany energy company, for Endesa, the leading utility in the Spanish system.

Should sovereign wealth funds, foreign state-owned monopolies, and national champions be allowed to invest freely? According to one opinion, the market should decide, because investors are a good thing and sovereign wealth funds should be allowed to invest as freely as any other investors.

According the view represented in section 17.4 and Volume I, some investors can be bad for the firm. The firm relies on its shareholders as important agents. It is possible that a certain shareholder tries to maximise its own private benefits regardless of the harm caused to the firm. The existence of such shareholders is bad for the firm and bad for the company's other shareholders.

Furthermore, some investors neither share the core values of market participants nor want to play by the market's rules. For example, a foreign country may try to take over a company for the purpose of furthering its own policy interests regardless of the interests of the firm or its other shareholders.

Such policy interests can be contrary to the public policy interests of the host country (the target company's home country). For example, Russia might prefer to buy control over the European gas distribution network in order to further its own long-term foreign policy interests. In such a situation, it would be normal for a Member State of the EU to protect its own legitimate public policy interests.

To sum up: Many sovereign wealth funds and national champions act like "normal" institutional or trade investors. Many of them are good long-term investors whose interests are aligned with those of the firm and other long-term share-

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holders. However, some sovereign wealth funds can be bad for the firm or the host country.

15.2 Community Law

The freedom of establishment applies to "natural persons" as well as "companies and firms". This means that even state-owned companies and firms can benefit from it.

On the other hand, the provisions of the chapter on freedom of establishment "shall not apply, so far as *any* given Member State is concerned, to *activities* which in that State are connected, even occasionally, with the exercise of *official authority*".[1] According to the wording of the EC Treaty, there is no distinction between activities in the home country (outward direct investment) and activities in the host country (inward direct investment).

Furthermore, the EC Treaty does not prevent restrictions or special treatment for foreign nationals justified on grounds of public policy or public security.[2] Some restrictions are thus permitted on such grounds.

Degree of protection. In the absence of harmonisation at Community level, it is generally for the Member States to decide on the degree of protection which they wish to afford to such legitimate interests and on the way in which that protection is to be achieved.

Constraints. They may do so, however, only within the limits set by the Treaty and must, in particular, observe the principle of proportionality, which requires that the measures adopted be appropriate to secure the attainment of the objective which they pursue and not go beyond what is necessary in order to attain it.[3]

In 2008, Germany passed legislation giving the federal government the right to veto any foreign non-EU investment of more than 25% in key German firms. The new provisions of the Außenwirtschaftsgesetz are aimed at state-owned sovereign wealth funds. The restrictions apply regardless of the size of the target firm. There are restrictions even in other European countries. In the UK, reasons for review or restrictions are based on the Enterprise Act of 2002. In France, they are based on Decree No. 1739 of 2005.

No reciprocity. The absence of harmonisation means that there is no reciprocity requirement under Community law. Restrictions applied by other countries are not relevant.

In the US, the Committee on Foreign Investment in the United States (CFIUS) is a multi-agency government committee that analyses the national security impact of foreign acquisi-

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[1] Article 45 of the EC Treaty.

[2] See, in particular, Articles 46(1) and 58(1) of the EC Treaty.

[3] Case C-112/05 Commission v Germany [2007] ECR I-8995. See also Case C-203/08 Konle [1999] ECR I-3099.

tions of US firms.[4] In Russia, foreign investments are restricted by the 2008 Law on Foreign Investment in Strategic Sectors.

International developments. The lack of transparency of sovereign wealth funds has made the IMF, OECD, and a group of sovereign wealth funds to work on best practices principles aimed at improved sovereign wealth fund transparency.

The International Working Group (IWG), a group of sovereign wealth funds facilitated by the IMF, has reached a preliminary agreement on a set of voluntary practices and principles referred to as the "Santiago Principles". In October 2008, the IWG presented its report on the Generally Accepted Principles and Practices for Sovereign Wealth Funds (GAPP).

In October 2008, the OECD Investment Committee adopted OECD Guidance for recipient country investment policies relating to national security. The OECD guidance for recipient countries (i.e. host countries) complements the Santiago Principles for sovereign wealth funds (i.e. home countries). The OECD has earlier adopted the OECD Guidelines on Corporate Governance of State-Owned Enterprises.

[4] Rose P, Sovereign Wealth Funds: Active or Passive Investors? Yale L J Pocket Part 118 (2008) pp 104–108.

16 Key Provisions of the Acquisition Agreement

16.1 General Remarks

The key provisions of the acquisition agreement regulate the structure of the acquisition, the separation of signing and closing, the disclosure of information, the specifications of the object (representations, warranties, covenants), the price, remedies in the event of breach of contract, the effect of the acquisition on employees, and tax.[1]

16.2 The Specifications of the Object

Representations, warranties, and covenants normally set out the specifications of the object. They make up the bulk of the acquisition agreement. The specifications of the object are normally defined in four ways: by defining the object (shares, assets); by defining the contract parties (identity of parties, representations); by defining warranties (the specifications that the object must have at the time of signing, closing, handing over of the object to the acquirer, or another point in time); and by defining covenants (the specifications that the object must have at a later point of time). However, there is variation partly caused by the governing law.

Purpose of specifications. To some extent, the vendor's representations, warranties, and covenants serve the same purpose as similar undertakings by the borrower in a loan facility agreement.

If the acquirer's perceived risk is reduced, the vendor may be able to obtain a better price. Through the use of agreed specifications of the object, the vendor may disclose information that only the vendor knows or to which only the vendor has access. Such undertakings also signal the vendor's ability and willingness to comply with them.

The vendor can try to use "as is" provisions and language that limits the number and scope of its undertakings. However, this can: signal that the vendor wants to benefit from information asymmetries; allocate risk to the acquirer; and reduce price.

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[1] Goldberg L, Acquisition Agreements from a Business Perspective (Principal Focus: Private Company Acquisition for Cash). In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice, Corporate Law and Practice Course Handbook Series. New York City (2008).

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Specifications under legal background rules: caveat emptor. In the absence of particular representations, warranties, or covenants, the specifications of the object are determined by legal background rules. A party should therefore understand what its rights and obligations would be if the parties did not reach agreement on a particular question.

To begin with, the contractual specifications of the object are governed by the law governing the contract.[2]

From a contract law perspective, there are four preliminary questions influencing contents of the legal background rules. What is regarded as the object in a share deal or an asset deal? Is the transaction governed by rules applicable to the sale of movable goods or rules applicable to the sale of rights?[3] When is there an enforceable promise? Is there a classification of promises?

However, the traditional starting point is that the specifications of the business enterprise are determined by the *caveat emptor* principle: if the seller has promised nothing, the buyer cannot expect anything. This rule can apply even where the object must have "*normal qualities*" under the legal background rules.

A business enterprise cannot be deemed to have any normal qualities that would be common to all or most business enterprises, because all business enterprises are different.

In an *asset deal* for the sale and purchase of a business enterprise, the main rule is therefore that the business enterprise must comply with the agreed specifications but does not have to comply with any statutory specifications – the main rule is that there are no particular statutory specifications. The specifications of the object should therefore be based on express contract terms. This applies where the sale is regarded as the sale of a business enterprise (say, the business of a transport firm) rather than as the sale of particular goods (say, all ten Scania trucks owned by that transport firm). In the latter case, the agreed specifications can be complemented by legal background rules setting out the normal specifications of such particular goods (the expected quality of a Scania truck).[4]

In a *share deal*, the main rule is that the vendor sells rights attaching to shares and not a business enterprise. In many countries, the seller of a right is responsible for the existence of that right (veritas) but not for its quality (bonitas).[5] However, in some countries, attempts have been made to regard the sale of a large block of shares as the sale of a business enterprise. This has led to problems of interpretation (see below and section 16.4).

Specifications under legal background rules: information, interpretation, exceptions. The main rule of caveat emptor is complemented by a number of core information and interpretation rules which can make the vendor responsible for the

[2] See Articles 1(1) and 12(1) of Regulation 593/2008 (Rome I).

[3] See, for example, Mäntysaari P, Mängelhaftung beim Kauf von Gesellschaftsanteilen. Swedish School of Economics and Business Administration, Helsingfors (1998).

[4] See DCFR IV.A.–2:302; PECL Article 6:108. See also CISG Article 35.

[5] DCFR III.–5:112. For example, § 9 of the Finnish and Swedish Promissory Notes Act (skuldebrevslagen) lays down such a principle. Under German law, there is also a related distinction between the liability of the vendor of rights (Rechtsmängelhaftung) and the liability of the vendor of movable good (Sachmängelhaftung).

existence of certain characteristics or the absence of unwanted characteristics: (a) The acquirer is protected by the prohibition of *fraud* (Volume II). (b) Furthermore, the object must possess the *agreed* specifications both in a share deal and in an asset deal, and it is a matter of *interpretation* when parties can be deemed to have agreed on something (Volume II). (c) In particular, interpretation is influenced by *actual disclosures*. If the vendor has disclosed information to the acquirer and that information was relevant to the acquirer, the court might hold that the parties have agreed that the object must comply with the information disclosed. This makes the management of information flows very important especially to the vendor (see below). (d) In some cases, the vendor may be deemed to have an *active duty to disclose* facts which it should know to be relevant to the acquirer (see below). (e) On the other hand, interpretation is also influenced by the acquirer's *knowledge* of facts. It is a well-known rule that the vendor is not liable for breach of contract if, at the time of contracting, the buyer knew or should have known about the circumstances that the buyer invokes as alleged breach.[6] This makes the management of information flows very important also to the acquirer.

For example, the vendor often makes disclosures in a "Letter of Disclosure" or annexed to the contract because the acquirer's knowledge about facts disclosed reduces the vendor's liability for their existence. Representations and warranties should therefore be read in conjunction with the disclosure schedules. The buyer bears the risk for things mentioned on the disclosure schedules. The seller often wants to disclose as much information as late as possible (when the deal is almost done) because: this can reduce the vendor's liability; the acquirer does not have time to inspect the information carefully (negative details perhaps go unnoticed); and this can reduce the risk that the acquirer walks away and uses information disclosed by the acquirer for business purposes. In contrast, the buyer needs to have enough time to inspect the draft agreement and disclosure schedules, as well as to perform due diligence.[7] – According to the case law of the German BGH in asset deals, the vendor has an active duty to disclose facts which may frustrate the purpose of the deal and which thus are relevant to the acquirer, provided that acquirers would normally have expected such facts to be disclosed.[8] This rule is applied regardless of the main rule according to which the vendor of goods has no general duty of disclosure (§ 433 BGB).

There can also be other exceptions to the main rule of caveat emptor. The most important exception is that the sale of all or practically all shares of the company can be regarded as an asset deal instead of a share deal in some countries (see sec-

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6 CISG Article 35(3); DCFR IV.A.–2:307.

7 Goldberg L, *op cit*, pp 219–221.

8 BGH, judgment of 28.11.2001 - VIII ZR 37/01: "Zwar ist hier ebenfalls von dem Grundsatz auszugehen, dass bei Verhandlungen über einen Unternehmenskauf der Verkäufer den Kaufinteressenten auch ungefragt über solche Umstände aufzuklären hat, die den Vertragszweck (des anderen) vereiteln können und daher für seinen Entschluss von wesentlicher Bedeutung sind, sofern er die Mitteilung nach der Verkehrsauffassung erwarten konnte … Überdies trifft den Verkäufer in solchen Fällen … im Hinblick auf die wirtschaftliche Tragweite des Geschäfts und die regelmäßig erschwerte Bewertung des Kaufobjekts durch den Kaufinteressenten grundsätzlich eine gesteigerte Aufklärungs- und Sorgfaltspflicht."

tion 16.4). Typically, what such a rule means is unclear. In practice, it can influence three fundamental things: the scope of rules governing the sale of goods (under German law, the applicability of Sachmängelhaftung instead of Rechtsmängelhaftung); the applicability of rules setting out the statutory specifications of the object; and the assessment of the amount of damage and the amount of price reduction.

Because of the general flexibility of the interpretation of law and the particular risks caused by the application of traditional contract law rules to acquisitions, it is in the interests of both parties to regulate the specifications of the object in the contract and not rely on legal background rules. For the acquirer, the use of detailed contract terms on the specifications of the object belong to the most important ways to mitigate risks inherent in the interpretation of contracts, counterparty commercial risk, and problems caused by the agency relationship between the acquirer and its contract party.[9]

In order to reduce legal risk, the parties should also regulate the consequences of the breach of such contract terms.

Vendor's representations and warranties: survival. The main rule is that a party's actual or constructive knowledge of lack of conformity excludes the other party's liability.[10] In practice, this can mean that some of the vendor's representations and warranties will not survive buyer due diligence (section 13.3.3). If the acquirer wants the representations and warranties to be enforceable regardless of its actual or constructive knowledge in general and the due diligence inspection in particular, it should ensure that the contract contains an express clause to this effect.

Vendor's representations and warranties: classification of promises. Normally, the vendor's representations and warranties have a broad scope. In addition, the vendor represents and warrants that its declarations are true and correct as of a certain date, typically both on the signing date and on the closing date.

Although the terms "representations" and "warranties" are often used interchangeably, they are not always interchangeable. Different kinds of promises can be combined with different legal consequences depending on the governing law.

US. This can be illustrated by certain differences between US, English, and German law. In the US, there are substantial legal reasons for the protected party (the acquirer) to require both representations and warranties. (a) Common law "representations" are statements of present or past fact ("facts" cannot relate to the future). The aggrieved party can make a common law claim of deceit and allege fraudulent misrepresentation, if a representation is intentionally false. In addition to rescission, fraud can lead to punitive damages. (b) In *CBS Inc. v. Ziff-Davis Publishing Co.,*[11] a common law "warranty" was defined as a promise of indemnity if a statement of fact is false. This means that the other party may sue for breach of warranty and recover damages despite knowledge of the falsity of the statement.

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9 Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 175–177.

10 CISG Article 35(3); DCFR IV.A.–2:307.

11 CBS Inc. v. Ziff-Davis Publishing Co., 75 N.Y.2d 496 (1990).

England. In English M&A practice, sellers resist giving representations in addition to warranties. (a) According to the traditional approach, a contract term is either a condition or a warranty. If it is a condition, any breach of the condition gives the aggrieved party a right to rescind the contract. (b) If it is a warranty, the injured party is entitled to damages.[12] (c) On the other hand, the distinction between conditions and warranties has fallen out of favour. There is also a flexible category of intermediate (or innominate) terms.[13] In this case, the right to rescind the contract depends on the gravity of the breach. In the modern law, the main rule is that any term of a contract can be classified as an intermediate term.[14] (d) In the past, the consequences of misrepresentations depended on the misrepresentation. Apart from the Hedley Byrne principle,[15] damages were not recoverable for a non-fraudulent misreprensation. However, the Misrepresentation Act of 1967 increased the liability for non-fraudulent and fraudulent misrepresentations.

Germany. In German contract law, the seller will try to avoid "guaranteed characteristics". The main distinction is that between general conformity requirements (the absence of defects, Mängel) and guaranteed characteristics (Beschaffenheitsgarantie, Haltbarkeitsgarantie). In the latter case, contractual limitation of liability clauses do not apply.[16]

In purely domestic transactions, the benefit of classifying contract terms as belonging to certain categories can be that of legal certainty. In cross-border transactions, however, the certainty may be lost. The *acquirer* can mitigate legal risk by using representations and warranties jointly. The acquirer will then receive both "representations and warranties". The *vendor* should understand the classification of contract terms under the governing law in order to mitigate risk. *Both* parties can mitigate risk by agreeing on detailed sanctions for breach of the terms of the contract.

Generally, representations and warranties lay down mere moral obligations unless they are complemented by sufficient *sanctions* for their breach (section 16.4). The acquirer should always investigate whether each representation and warranty is complemented by clear sanctions. For example, it may be difficult for the acquirer to show the exact amount of loss caused by breach of warranty. The contract should therefore contain an express term on liquidated damages and/or a term setting out the effect of the breach on price.

There is also the question of time. It goes without saying that the acquirer will not be protected by any undertakings of the vendor or any security for the fulfilment of the vendor's obligations to the extent that the acquirer's right to invoke those obligations has expired because of a *statute of limitation* or otherwise. The parties often agree that representations and warranties survive the closing for a certion period of time during which the acquirer may make indemnification claims. The acquirer often seeks to ensure that the survival period will run through at least one audit cycle. Some core representations (such as title to shares being

[12] Bettini v Gye (1876) 1 QBD 183.

[13] Hong Kong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd [1962] 2 QB 26; Cehave N.V. v Bremer Handelsgesellschaft mbH (The Hansa Nord) [1976] QB 44.

[14] Beatson J, Anson's Law of Contract. 27th Edition, OUP, Oxford (1998) pp 138–141.

[15] Hedley Byrne & Co Ltd v Heller & Partners Ltd [1964] AC 465.

[16] § 444 BGB.

sold) and special areas (such as tax liability, environmental liability) may survive past the general survival period.[17]

Vendor's representations. As explained above, representations and warranties are often used interchangeably (which can increase legal risk for the parties) or jointly (in order to mitigate the acquirer's legal risks). For this reason, they often address similar questions.

If representations and warranties are used separately, the vendor's representations are often fact statements about the vendor. Representations typically address counterparty corporate risk (for the distinction between counterparty corporate risk and counterparty commercial risk, see Volume II). Representations are usually more or less similar regardless of the transaction.

Representations contain terms which state that the contract is binding and enforceable. In particular, a party represents: that it has power to conclude binding contracts in general (capacity); that its representatives have power to conclude binding contracts on its behalf (power and authority); and that the contract is binding.

In order for the contract to be binding and enforceable, a number of legal conditions relating to the party must have been fulfilled: the party must be incorporated as a legal person and validly existing; the party must have taken care of all internal corporate action to authorise the transaction and to execute it; all necessary regulatory approvals must have been obtained; and there must not be any circumstances that threaten the existence of the party as a legal person or the enforceability of contracts concluded by it.

Vendor's warranties. If the representations of the vendor are used as fact statements about the vendor itself, warranties can be used as fact statements about the object. Compared with representations, their contents are more transaction-specific. Warranties typically regulate the specifications of the object, the agreed profitability of the object, and counterparty commercial risk.

In a share sale, warranties paint a picture of the target company, the shares that are being bought and sold, and the target company's business.

Vendor's warranties reflect the balance of bargaining power between the parties. In auctions, the increased negotiating leverage of the vendor means that bidders may be offered just a few broader warranties on the financial statements as a whole and perhaps specific detailed warranties limited to areas of concern identified in due diligence. Another approach is for the acquirer to request detailed warranties but accept qualification by information "fairly" disclosed in the data room (see below).[18]

Vendor's covenants. The vendor may undertake covenants. Restrictive covenants include both non-competition and non-solication clauses.

A non-competition clause typically attempts to prevent the vendor from competing with the acquirer within a certain product market and geographic area for a

[17] *Ibid*, pp 219–221.

[18] Schmidt KM, Private Equity: Current M&A Issues for Buyers. In: PLI, Eighth Annual Private Equity Forum, Corporate Law and Practice Course Handbook Series (2007) p 128.

certain period of time (for employee non-competition agreements, see also Volume I).

A non-solicitation clause is less restrictive as it typically aims to preclude a party from actively solicitating customers or employees of the target. Such restrictive covenants raise questions of enforceability under the law governing the contract as well as questions of competition law (section 16.3).

Qualification of vendor's representations, warranties and covenants. Rational vendors try to obtain information about their own future cash flows and regulate them in the contract (for payment obligations generally, see Volume II). In order to reduce risk, vendors try to qualify their obligations.

For this reason, business acquisition contracts normally contain caps and qualifiers such as materiality and knowledge clauses.

Business acquisition contracts contain materiality, de minimis, basket, or floor clauses according to which the acquirer's remedies will be triggered only after a certain threshold has been exceeded (section 16.4).[19] The vendor requires materiality clauses because of the nature of business acquisitions. The vendor typically does not have full information about the target, and most of the information that it does have consists of estimates verified some time before signing or closing rather than accurate information about exact facts verified at signing and closing. Without materiality clauses, sanctions for misrepresentations and other breaches of contract would be triggered too easily.

The vendor's representations and warranties are frequently qualified by knowledge clauses (generally, see Volume II). In addition, there can be different definitions of knowledge ranging from seller-friendly to buyer-friendly: "to the actual knowledge of"; "to the actual knowledge, after reasonable inquiry, of [names]"; and "to the knowledge of".[20]

The acquirer's representations and warranties. If the agreement contains separate (generic) representations and (transaction-specific) warranties, the acquirer can normally make the same representations as the vendor. The warranties of the acquirer typically depend on the means of payment and type of consideration.

Where the acquirer pays a cash consideration against the delivery of the object, it is sufficient that the contract is binding (just representations). Where the acquirer is granted payment time, the contract is likely to provide for credit enhancements for the security of payment (representations, some warranties and some covenants). Where the consideration consists of shares issued by the acquirer, the transaction really consists of two acquisitions. The acquirer may require usual representations and warranties from the vendor, but the acquirer may have to give similar representations and warranties in its capacity as issuer of shares.

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[19] For materiality clauses and caps, see, for example, Hilgard MC, Bagatell- und Cap-Klauseln beim Unternehmenskauf, BB 2004 pp 1233–1239.

[20] Goldberg L, *op cit*, pp 219–221.

16.3 Excursion: Non-Competition Clauses

The risk of competition by the vendor is likely to reduce the price that the acquirer is willing to pay and future competition by the vendor is, in many cases, a deal-breaker.[21] Depending on the acquisition, the vendor can have full information about the target and its business including information about all its customers, their contact persons, and their preferences. The acquirer will not have full information about the target and its business immediately after closing. If the vendor starts competing with the target immediately after closing, the acquirer may lose not only customers but also key resources such as personnel to the vendor. Furthermore, if the vendor intends to start competing with the target after the acquisition, the vendor has an incentive to disclose less before closing.

For such reasons, non-competition clauses and similar restrictive covenants are frequently used in acquisition agreements.

However, such terms are constrained by: mandatory provisions of contract law making unreasonable contract terms unenforceable or not binding (Volume II);[22] provisions of national competition laws;[23] and provisions of EU competition law.[24]

Non-competition clauses under EU competition law. Non-competition clauses are clearly agreements that can fall within the scope of Article 81(1) or Article 82 of the EC Treaty (for sanctions, see Volume II).

To understand the position of EU competition law, it is helpful to study US antitrust law first. Judge Taft's decision in the *Addyston Pipe* case of 1898[25] recognised that certain consensual restraints may ultimately promote competition and introduced the ancillary restraints doctrine into antitrust law. According to the ancillary restraints doctrine, some agreements which restrain competition may be valid if they are subordinate and collateral to another legitimate transaction and necessary to make that transaction effective.[26]

Under EU competition law, non-competition clauses can be permitted as ancillary restrictions. The concept of an ancillary restriction covers any restriction which is directly related and necessary to the implementation of a main operation which is permitted.[27] Non-solicitation and confidentiality clauses have a comparable effect and are therefore evaluated in a similar way to non-competition clauses.[28]

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[21] See, for example, Case T-112/99 Métropole télévision (M6) and others v Commission [2001] ECR II-2459 paragraph 111.

[22] For example, § 138 BGB (Sittenwidrigkeit).

[23] For example, § 1 GWB.

[24] Article 81 of the EC Treaty.

[25] United States v Addyston Pipe & Steel Co., 85 F. 271 (6th Cir. 1898), modified and affirmed, 175 U.S. 211 (1899).

[26] See Bork RH, The Rule of Reason and the Per Se Concept: Price Fixing and Market Division, Yale L J 74 (1965) pp 775, 797–798.

[27] See, for example, Case T-112/99 Métropole télévision (M6) and others v Commission [2001] ECR II-2459, paragraph 104.

[28] Commission Notice on restrictions directly related and necessary to concentrations, OJ C 56, 5 March 2005 pp 24–31, paragraph 26.

Ancillary and necessary restrictions. The condition that an ancillary restriction be necessary implies a two-fold examination.

First, one has to establish whether the restriction is *objectively necessary* for the implementation of the main operation.[29] The ECJ recognises the risk that the vendor, with its particularly detailed knowledge of the transferred undertaking, can be in a position to win back its former customers immediately after the transfer and thereby drive the undertaking out of business. In *Remia v Commission*, the ECJ therefore held that a non-competition clause is objectively necessary for a successful transfer of undertakings where it is clear that there would not be any agreement for the transfer of the undertaking if the vendor and the purchaser remained competitors after the transfer without such a clause.[30]

Second, where a restriction is objectively necessary to implement a main operation, it is still necessary to verify whether the restriction is *proportionate* to it,[31] i.e. whether its duration and its material and geographic scope do not exceed what is necessary to implement that operation. If the duration or the scope of the restriction exceed what is necessary in order to implement the operation, it must be assessed separately under Article 81(3) of the EC Treaty.[32]

In its decisions, the Commission has found that a number of restrictions were objectively necessary to implementing certain operations. Failing such restrictions, the operation in question could not be implemented or could only be implemented under more uncertain conditions, at substantially higher cost, over an appreciably longer period, or with considerably less probability of success.[33]

According to Commission notice on ancillary restrictions,[34] non-competition obligations which are imposed on the vendor can be necessary to the implementation of the concentration.[35] However, such non-competition clauses are only justified "by the legitimate objective of implementing the concentration when their duration, their geographical field of application, their subject matter and the persons subject to them do not exceed what is reasonably necessary to achieve that end".[36]

Non-competition clauses are justified for periods of up to two or three years, depending on whether the transfer of the undertaking includes the transfer of customer loyalty in the form of both goodwill and know-how.[37]

Clauses which limit the vendor's right to purchase or hold shares in a company competing with the business transferred are considered directly related and neces-

[29] See, for example, Case T-112/99 Métropole télévision (M6) and others v Commission [2001] ECR II-2459, paragraph 106.

[30] Case 42/84 Remia v Commission [1985] ECR 2545, paragraph 19; Case T-112/99 Métropole télévision (M6) and others v Commission [2001] ECR II-2459, paragraph 110.

[31] See Métropole télévision, *ibid*, paragraph 106.

[32] Métropole télévision, paragraph 113.

[33] Métropole télévision, paragraph 111.

[34] Commission Notice on restrictions directly related and necessary to concentrations, OJ C 56, 5 March 2005 pp 24–31.

[35] Commission Notice, paragraph 18.

[36] Commission Notice, paragraph 19.

[37] Commission Notice, paragraph 20.

sary to the implementation of the concentration under the same conditions, unless they prevent the vendor from purchasing or holding shares purely for financial investment purposes.[38]

Non-competition clauses are not considered necessary "when the transfer is in fact limited to physical assets (such as land, buildings or machinery) or to exclusive industrial and commercial property rights".[39] There are even restrictions as to geographical scope, products, and parties.[40]

Where the concentration as a whole falls within the scope of the EC Merger Regulation, even non-competition clauses are covered by the EC Merger Regulation. According to the Regulation, a decision declaring a concentration compatible with the common market "shall be deemed to cover restrictions directly related and necessary to the implementation of the concentration" (ancillary restraints).[41]

Non-competition clauses under Member States' national laws. As a rule, non-competition clauses must be permitted under the national provisions of Member States laws where they are necessary for the attainment of the purpose of an otherwise legal contract. For example, the application of § 1 of the German Cartel Act (GWB), which resembles Article 81(1) of the EC Treaty and prohibits agreements that restrict competition, is constrained by the "theory of immanence" (Immanenztheorie) to that effect.[42]

16.4 Remedies (Indemnities)

Indemnities provide the buyer with remedies for: (a) breaches of representations, warranties, and covenants; and (b) specific, known liabilities that the seller has agreed to continue to bear.[43] As explained earlier, it is in the interests of both parties to agree on remedies for breach of representations and warranties and breach of contract in general. Furthermore, all statutory remedies cannot easily be applied to a business acquisition contract. For example, it is notoriously difficult to rescind a business acquisition contract.

The agreed remedies contain at least damages and/or the adjustment of the purchase price (section 16.5.3). The choice of remedies depends on the balance of the parties' bargaining power. For example, the vendor may try to resist broad general indemnities (as it can be difficult to assess their cost, see Volume II) but may be willing to accept specific indemnities against specific losses arising from identified, concrete, precompletion exposures (which the vendor may be in a better posi-

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[38] Commission Notice, paragraph 25.

[39] Commission Notice, paragraph 21.

[40] Commission Notice, paragraphs 22–24.

[41] Article 6(1)(b), second subparagraph, Article 8(1), second subparagraph, and Article 8(2), third subparagraph of Regulation 139/2004 (EC Merger Regulation).

[42] For some comparative remarks, see Lüscher C, Konkurrenzverbote bei Unternehmensverkäufen - ein Problembereich der Wertabstimmung zwischen Privatrecht und Kartellrecht? ZSR 2002 pp 345–386 at pp 354–355.

[43] Goldberg L, *op cit*, pp 218–219.

tion to assess).[44] The vendor will also try to qualify its obligations by materiality clauses and use caps and limitation of liability clauses.

Classification of the deal and the scope of statutory remedies. The nature of remedies and their application under the legal background rules typically depend on:

- the classification of the object as shares or assets (in some countries, the sale of all or practically all shares can be regarded as the sale of all assets of the target company);
- the effect of the classification on the scope of legal rules on the sale of movable goods and rights (if the sale of shares is regarded as the sale of all assets of the target company, typically legal rules on the sale of movable goods can apply); and
- the effect of the classification on the application of the legal background rules on the normal quality of the object, damages, and price reduction (if the sale of shares indeed is regarded as the sale of all assets of the target company and the sale is governed by legal rules on the sale of movable goods, it remains to be decided how far a share deal is regarded as an asset deal).

This can be illustrated by the traditional position of German case-law according to which a share deal can be regarded as an asset deal when sufficiently many shares are sold.[45] German case-law has influenced part of the doctrine in the Nordic countries.[46]

If the share deal was regarded as an asset deal, the sale was governed by the original provisions of the BGB on the sale of movable goods. The applicable provisions also influenced the required characteristics of the object and the remedies available to the acquirer.[47] The previous differences between liability rules applicable to the sale of movable goods and the sale of rights under German law were abolished through new rules introduced by the Schuldrechtsmodernisierungsgesetz which codified and unified the liability system.[48] This means that the same liability rules now apply to share deals and asset deals.[49] However, the distinction between the sale of goods (Sachkauf) and the sale of rights (Rechtskauf) re-

[44] Schmidt KM, Private Equity: Current M&A Issues for Buyers. In: PLI, Eighth Annual Private Equity Forum, Corporate Law and Practice Course Handbook Series (2007) p 129.

[45] See, for example, BGHZ 65, 246 and already RGZ 120, 283.

[46] See Mäntysaari P, Mängelhaftung beim Kauf von Gesellschaftsanteilen. Swedish School of Economics and Business Administration, Helsingfors (1998).

[47] See, for example, Gaul B, Schuldrechtsmodernisierung und Unternehmenskauf, ZHR 166 (2002) pp 40–41.

[48] § 437 BGB. The Schuldrechtsmodernisierunsgesetz entered into force on 1 January 2002. See, for example, Gaul B, Schuldrechtsmodernisierung und Unternehmenskauf, ZHR 166 (2002) pp 35–71; Schröcker S, Unternehmenskauf und Anteilskauf nach der Schuldrechtsreform, ZGR 2005 pp 63–100; Triebel V, Hölzle G, Schuldrechtsreform und Unternehmenskaufverträge, BB 2002 pp 521–537.

[49] See in particular § 453 BGB.

mains[50] and it is unclear to what extent the old case-law can or cannot be applied to share deals and asset deals.[51] This has increased interpretation of law risk in acquisition agreements and made it even more necessary for the parties to regulate all terms expressly in the contract. Because of the new provisions of the BGB, the parties will pay attention to whether the vendor's promises concerning the specifications of object would be interpreted[52] as "dependent guarantees" or "independent guarantees". Breach of the latter is combined with a heavier duty to pay damages.[53]

The doctrine of regarding a share deal as an asset deal is fundamentally flawed, because it is impossible to draw a line between these two forms of share deal. Furthermore, the unrestricted application of asset deal remedies to a share deal as if the share deal actually were an asset deal would be likely to enrich buyers at the cost of sellers.

For example, let us assume that the buyer has paid €1 for shares of a company which, according to the terms of the acquisition agreement, owns a machine worth €1 million and other assets. If it turns out that the company does not own the machine, the buyer of shares will sustain a loss up to €1 and the buyer of assets a loss up to €1 million, to simplify the matter. Only the buyer of the machine would have sustained a loss of €1 million. It is possible that the failure of the target company to own the machine would not have had any material effect on the valuation of the company's shares. For example, the company's balance sheet may be €1 billion.[54]

Statutory remedies. Depending on the governing law, the buyer of movable goods might have a right to: claim damages; claim a price reduction; claim performance; require the seller to remedy the lack of conformity by repair; or declare the contract avoided. Most of such remedies are not mutually exclusive (cumulation or remedies).[55]

However, the only remedies that can easily be applied to share deals and assets deals are the right to claim damages and/or a price reduction.

Rescission of a business acquisition contract is notoriously difficult, because the buyer has taken control of the business and cannot return the business in the same condition to the seller as when the buyer received it from the seller. This is one of the factors that make conditions precedent to closing so important.

Even the right to claim damages and the right to claim a price reduction can be problematic. To begin with, there are problems relating to evidence, causation, and the valuation of the target: the buyer cannot always prove breach of contract; the buyer cannot always show that the buyer has actually sustained loss or damage from the breach; and the buyer cannot always show that the breach would have influenced price, because a shortfall in warranted assets and other breaches of war-

50 §§ 433 and 453 BGB.
51 Schröcker S, *op cit*, p 64.
52 §§ 133 and 157 BGB.
53 §§ 443 and 444 BGB.
54 Generally, Mäntysaari P, Mängelhaftung beim Kauf von Gesellschaftsanteilen. Swedish School of Economics and Business Administration, Helsingfors (1998).
55 See, for example, CISG Article 45; § 437 BGB; DCFR III.–3:102.

ranty will not necessarily be regarded as circumstances that would change the valuation of the target as a whole. In addition, there is the problem of counterparty credit risk: if the seller has used the proceeds, the seller may be unable to pay.

Agreed indemnities for breach of contract. The acquirer should therefore ensure that the parties have regulated the question of remedies for breach of contract. The acquirer is not sufficiently protected if the parties have agreed on the specifications of the object and not much else.

The acquirer should ensure that the contract sets out what it means if the vendor is responsible for misrepresentations or breach of contract. There should be a clear mechanism to calculate their effect on price or damages.

Different remedies should apply to breaches of different categories of terms. For example, it is not meaningful to agree that all misrepresentations amount to breach of contract and give the buyer a right to claim large damages or a large price reduction.

The vendor will therefore require de minimis exclusions (materiality clauses). The parties often agree that the vendor is responsible for material misrepresentations or for misrepresentations that exceed a certain threshold (a euro amount depending on deal size or a percentage threshold, for example, 1%-2%).

The vendor will require a cap to its liability. The cap can be a certain percentage of the purchase price or a fixed maximum amount. The vendor may not invoke caps in the event of fraud or when it has caused damage wilfully or through gross negligence (for limitation of liability clauses, see Volume II).[56] The cap acceptable to the vendor can depend on the nature of the vendor and the market and whether an M&A insurance policy is used. Whereas a traditional industrial vendor can accept a higher cap (for example, 30%-50% of the purchase price), a financial investor who plans to distribute the purchase price to its own investors immediately after closing will insist on a much lower cap. The use of an M&A insurance (see below) can enable the parties to agree on a very low cap (for example, 1%-2% of the purchase price).

In addition to general materiality clauses and caps that apply to its liability in general, the vendor can also try to limit its liability for certain specific facts by materiality clauses or caps that cover its warranties for those facts.

The acquirer can try to ensure that the qualifiers, de minimis exclusions and caps are not cumulative and that they do not provide for a "double-dip" for the vendor.[57]

Who may benefit from indemnities? The acquisition agreement is a contract between its parties and only those parties may rely on it. On the other hand, most of the representations and warranties of the vendor relate to the specifications of the target. In a share deal, they relate to circumstances of the target company. Nor-

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[56] For German law, see §§ 276 and 444 BGB. For the possible effects of § 444 BGB on contract practice, see Jaques H, Haftung des Verkäufers für arglistiges Verhalten beim Unternehmenskauf - zugleich eine Stellungnahme zu § 444 BGB n. F., BB 2002 pp 417–423.

[57] Goldberg L, *op cit*, pp 218–219.

mally, the target company is not party to the agreement and may not rely on it, and the acquirer will only become a shareholder of the target company.

If it is the intention of the parties that the vendor shall reimburse either the vendor or the target company in full for any difference between the agreed specifications (in German: Soll-Beschaffenheit) of the target and its actual specifications (Ist-Beschaffenheit), the parties should ensure that there is an express term to this effect.

An obligation to put the *target company* in the *condition* in which it would have been if the representations and warranties had been true in every respect can cost the vendor much more than an obligation to put the *acquirer* in the *position* in which it would have been if the representations had been true in every respect. The condition of the target company influences the position of the acquirer only indirectly, if at all.

The need to agree on indemnities in detail can be illustrated by a clause in the agreement between MAN Nutzfahrzeuge AG and Western Star Trucks Holdings Limited for the purchase of the whole of the issued share capital of ERF (Holdings) plc:[58] "12.1 Indemnification in Favour of MAN. Subject to Section 12.3, Section 12.4 and Section 12.5, WS Holdings shall indemnify and hold each of MAN AG, its Affiliates, the ERF Companies and the Other ERF Subsidiaries (collectively, 'MAN Indemnified Persons') harmless of and from any Damages suffered by, imposed or asserted against any of the MAN Indemnified Persons as a result of, in respect of, connected with, or arising out of, under or pursuant to: (a) any failure of WS Holdings … to perform or fulfil any of their respective covenants under this agreement; (b) any breach or inaccuracy of any representation or warranty given by WS Holdings … contained in this Agreement ..."

MAN Nutzfahrzeuge AG claimed damages from Western Star's successor in title, Freightliner Limited, and from Ernst & Young. It turned out that the wording of the contract was not sufficiently clear. One of the main areas of dispute in the case concerned the amount that MAN Nutzfahrzeuge AG was entitled to recover if it were successful in its claim. The defendants argued, for example, that the right of recovery was limited to the indemnity provided by section 12.1 which was intended to put MAN Nutzfahrzeuge AG in the position in which it would have been if the representations had been true in every respect.[59]

Sometimes the vendor may indeed have agreed to pay the value of missing assets to the acquirer in full. If the acquisition was structured as a share deal, this is clearly overcompensation, and even more so when the acquirer did not buy all shares in the company.

Acquirer's credit risk exposure (escrow account). If the acquirer already has paid the purchase price, the potential liability of the vendor for misrepresentations and other breaches of contract means that the acquirer is exposed to a credit risk.

The acquirer typically mitigates this risk in three main ways. First, some of the purchase price may be payable only after a certain short period of time, or the purchase price can depend on the future profitability of the company and be payable

[58] Man Nutzfahrzeuge AG and another v Freightliner Ltd and another [2007] EWCA Civ 910.

[59] MAN Nutzfahrzeuge AG and others v Freightliner Ltd [2005] EWHC 2347 (Comm).

after a certain period of time. Second, part of the purchase price can be held in escrow pending due diligence. Third, some agreements create an escrow account in which part of the consideration is held back and forfeited if a representation or warranty turns out to be false.[60] An escrow account is an account held in a bank by a reliable party on behalf of third-party assets.[61]

For example, a stock exchange release of TeliaSonera, a Nordic telecommunications group, described the use of the following escrow arrangement: "The main shareholders of Vollvik Gruppen have irrevocably committed themselves to sell their shareholdings to TeliaSonera at a price of NOK 11.15 per share in cash. NOK 10.50 of the purchase price per share will be paid in cash at closing, and NOK 0.65 will be held in escrow for 365 days following closing as collateral for the representations and warranties made to the buyer."[62]

Mitigation of counterparty commercial risk: alignment of interests. Indemnities help to mitigate risk by aligning the interests of the parties. In addition to traditional indemnities, there can be alternative ways to align the interests of the parties.

For example, when Cerberus bought Chrysler from Daimler in 2007, Daimler retained a 19.9% stake in Chrysler. In addition, Daimler undertake to lend $1.5 billion to the target company. For Cerberus, this was also a way to reduce other risks (such as credit, replacement, refinancing, and operational risks).

Mitigation of counterparty commercial risk: information intermediaries. The buyer can to some extent transfer risk by turning to external information intermediaries. For example, the buyer can require that the target's lawyers and accountants verify the the contents of representations and warranties and give an opinion that the contents of representations and warranties are true. This can make them potentially liable for negligence (see Volume I).[63] An M&A insurance can enable the acquirer and the vendor to agree on a lower cap on the liability of the vendor.

Mitigation of counterparty commercial risk: M&A insurance. Insurance allows a policyholder to exchange the risk of a contingent liability for the certainty of a current premium payment.

Business acquisitions give rise to both potential and present liabilities. Potential liabilities of the target may arise out of its past activities (ranging from environmental liability and product safety to tax). Alternatively, the liability of the target

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[60] Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 175–177. For Swiss law, see Groner R, Private Equity – Recht. Stämpfli Verlag AG, Bern (2007) pp 195–197.

[61] Escrow services provided by law firms or audit firms do not fall within the scope of the MiFID. See Article 2(1)(c) of Directive 2004/39/EC (MiFID). However, they can fall within the scope of anti-money laundering obligations. See Article Article 2(1), recital 20, and Article 42 of Directive 2005/60/EC (prevention of the use of the financial system for the purpose of money laundering and terrorist financing).

[62] TeliaSonera, stock exchange release dated 6 July 2005.

[63] Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 175–177.

may be known but the amount or timing of payment is uncertain (for example, there may be a duty to make pension payments or to pay bonuses to employees).

Representations and warranties typically cover such things, and the acquirer will rely on representations and warranties when determining the purchase price. On the other hand, the parties may have very different views of the likelihood or impact of the liabilities. The vendor may not be prepared to tie up monies without an increase in the purchase price, and the buyer may not want to rely on unenforceable moral obligations like representations and warranties that either do not exist or exist but have been diluted by a low liability cap.

An M&A insurance policy can provide a solution.[64] The vendor will not need to hold monies in an escrow or reserve fund, and the acquirer will be protected by an enforceable obligation undertaken by an insurance company.

A Representation and Warranty Insurance is usually taken out by the acquirer. Typically, insurance protection is limited to expressly defined quantifiable things which are covered by representations and warranties and exist at the time of contracting. For example, the target's future profitability will not be covered. As an insurance contract is a contract that requires utmost good faith, the policy will not cover things known to the acquirer.

The insurance company will carry out its own due diligence inspection of the target and the documentation before issuing the policy.

There are also other types of insurance used in the context of business acquisitions. They range from Directors and Officers Insurance (D&O) to Finite Risk Insurance. One of the problems with M&A insurance is cost.

16.5 Purchase Price and the Payment Method

16.5.1 General Remarks

There are many ways to address the question of how, when and how much the acquirer must pay. Typical forms of payment include: the acquirer's own shares (share offer); an immediate cash payment (cash offer); a cash payment in the future (deferred payment, debt); and mezzanine instruments (convertible loan, preference shares). The consideration can be either fixed or variable and depend on the target's comformity with its agreed specifications, the future profitability of the business, or future events. Furthermore, the acquirer may choose an all-cash method, an all-stock method, or a mixed offer.

[64] See Paar R, Protect Your Deals with M&A Insurance, The Corporate Board, September/October 2002.

16.5.2 Choice of the Payment Method

The acquirer should of course seek a form of payment that is both attractive to the vendor and acceptable to the acquirer itself. The choice of the payment method depends on the circumstances as the following examples can illustrate:

- A public share exchange offer to relatively uninformed target shareholders may cause a negative market reaction as investors hedge against the possibility that the bidder's shares are overpriced.[65]
- A high market valuation of the acquirer's shares encourages the acquirer to use its overpriced shares as a means of payment. According to a study, bids in fact tend to look better in the eyes of the target when the market is overvalued.[66]
- In share deals and share offers, contingent payment forms allow the acquirer and the vendor to share the risk that the acquirer's or target's shares are overvalued.[67]
- Mixed offers can be attractive, because neither party knows the true value of the other firm or its shares (two-sided information asymmetry).[68]
- Some bidders select cash over shares to avoid diluting private benefits of control.[69]

Cash payment. A cash payment can be attractive to the vendor as the vendor can use cash immediately, either for consumption or reinvestment, without having to incur any cost. The vendor may be able to get a better price when it uses a combination of different kinds of payment obligations including contingent payments (for the adjustment of the purchase price, see section 16.5.3 below).

From the perspective of the acquirer, a cash payment can cause problems, because cash may not be available or might only be raised by borrowing or issuing shares or loan stock to investors for cash.[70]

If the form of consideration is anything other than cash, the price term tends to become fairly complex.[71]

Shares. Where the vendor receives shares that it does not wish to keep, it must incur cost and effort to turn them into cash. However, shares may be attractive to a vendor who prefers to become shareholder in the acquirer. In many cases, the ownership of shares brings private benefits (Volume I).

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65 See Betton S, Eckbo BE, Thorburn KS, Corporate Takeovers. In: Eckbo BE (ed), Handbook of Corporate Finance: Empirical Corporate Finance, Volume 2. North-Hollande/Elsevier, Handbooks in Finance Series (2008), Chapter 15.

66 Rhodes-Kropf M, Viswanathan S, Market Valuation and Merger Waves, J Fin 59 (2004) pp 2685–2718. See Betton S, Eckbo BE, Thorburn KS, *op cit*.

67 Betton S, Eckbo BE, Thorburn KS, *op cit*.

68 See *ibid*.

69 See *ibid*.

70 McLaney E, Business Finance. Sixth edition. Pearson Education, Harlow (2003) p 381.

71 See Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 175–177.

From the perspective of the acquirer, a share exchange or the issuing of shares in consideration for assets means that less cash will need to be raised, and the acquirer will not be taking on the contractual commitments to pay interest or to repay capital. On the other hand, the issuing of shares to the vendor or vendors would change the share ownership structure of the firm, dilute the ownership of existing shareholders, and be subject to company law constraints.[72]

In a share exchange (a share offer in a share deal), a ratio of acquiring company to target company shares must be established. The ratio can be complicated, if there is a long delay between the signing of the acquisition agreement and the passing of the consideration at closing (see below).

Debt. Target shareholders receiving debt instruments that they do not wish to keep must again incur cost and effort to turn them into cash. Generally, the use of the acquirer's debt obligations as a means of payment would change the risk and return profile of the vendor's investment in a way that the vendor might not find acceptable.[73]

Where the vendor is skeptical about the future success of the merged business, the vendor might find debt instruments "safer" than equity capital.[74] On the other hand, as the payment of interest and capital depends on the success of the merged business, the vendor should again prefer cash.

Decisive factors. The choice between different forms of consideration can depend on many factors. Some factors can be regarded as decisive.[75]

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[72] McLaney E, *op cit*, pp 381– 382.

[73] *Ibid*.

[74] *Ibid*.

[75] See Rudolph B, Ökonomische Gesichtspunkte für die Wahl der Akquisitionswährung und Akquisitionsfinanzierung. In: Picot A et al (eds), Management von Akquisitionen. Schäffer-Poeschel, Stuttgart (2000) pp 131–151 at p 140; Schulte C, Corporate Finance. Die aktuellen Konzepte und Instrumente im Finanzmanagement. Vahlen, München (2006) p 247.

Table 16.1 Differences Between Cash Offers and Share Offers

Cash offer	*Share offer*
The acquirer's perceived risk is low and the acquirer prefers a high leverage.	The acquirer will be exposed to a high level of risk. For example, the acquirer does not have enough useful information about the target or the target has invested in high-risk projects.
The acquirer has surplus cash. For example, the acquirer may have a high cash-flow compared with the size of the target.	The acquirer has limited access to cash. For example, the cash flow of the acquirer may be small compared with the size of the target.
The acquirer has shareholder-value oriented corporate governance objectives when: it acquires a large target; it has controlling shareholders; and/or its managers hold a large block of shares in the acquiring firm.	The acquirer prefers to change its ownership structure. For example, the acquirer wants a more dispersed ownership structure or expects business benefits from the joining of the vendor as shareholder.
Shareholders' perceived risk is high.	The vendors' perceived risk is low. For example, vendors are more likely to accept a share offer in a bull market.
The acquisition is an MBO.	The acquirer is controlled by its management ("empire building").

16.5.3 Adjustment of Consideration

General Remarks

The simplest way to determine the purchase price is to agree on a fixed cash amount payable at closing. Price adjustments mechanisms can nevertheless lead to a higher or lower price. Such mechanisms are common when the target company is privately-owned, and in asset deals. The bookbuilding method is a particular way to adjust price in IPOs (see section 10.5.2). Price adjustment can take place at closing or after closing, and both in cash offers and share offers.

Cash Offers

In cash offers, the adjustment of purchase price can take place: at closing; after closing (variable purchase price); as a sanction for misstatements; and, in some cases particularly where the target is a listed company, by virtue of the principle of the equivalent treatment of all holders of securities of the same class.

At closing. The use of the customary conditions precedent to closing can give the acquirer an opportunity to renegotiate the purchase price. The acquirer should have ensured that it has an option to finalise the transaction even when conditions precedent have not been fulfilled (section 12.5 and Volume II). An unfavourable due diligence report, non-compliance with representations and warranties, a material adverse change, or any other condition precedent that has not been fulfilled

will then mean that the acquirer may walk away or renegotiate the purchase price before closing.

Price adjustment can also be based on particular contract terms. There are two main reasons for the parties to choose the adjustment of purchase price at closing.

First, the parties may leave the exact purchase price open at signing but agree on how the purchase price will be determined and fix the purchase price at closing on the basis of the outcome of due diligence.

Second, the parties may start with a certain agreed purchase price at closing. However, there can be a long delay between the signing of the acquisition agreement and the payment of purchase price at closing. If there is no purchase price adjustment mechanism, profits and losses of the target between signing and closing are for the account of the buyer. The parties can therefore agree on the adjustment of the purchase price at closing. Typically, the parties agree on financial or other targets and how the actual circumstances influence the purchase price. If the actual circumstances at closing are not equal to the agreed targets, either the buyer or the seller is responsible for the difference.[76]

After closing. The parties may agree to use variable payments for many reasons (Volume II). In business acquisitions, the acquirer typically does not know in advance whether the quality of the target will be what the vendor has promised. Because of risks caused by information asymmetries, the acquirer wants to pay less for the target. On the other hand, the vendor does not necessarily know everything about the target unless the vendor is a well-informed controlling shareholder or the deal is an asset deal. Because of the lack of useful information, the vendor may not want to give extensive representations and warranties about the target's business. This can reduce the price even more. The vendor can signal that the price is based on the true quality of the target's business, if the purchase price will be fixed after closing and after the parties have had an opportunity to verify the quality.

The parties can use a combination of different kinds of payment obligations to mitigate risk for the acquirer and/or reach agreement on a higher purchase price. Generally, however, deferred payment will increase the vendor's credit risk exposure (Chapter 20). (a) A fixed component of the purchase price may be payable on a certain date in the future. A promissory note from the buyer may be secured by the assets of the business or otherwise. (b) An earn-out clause can provide that part of the purchase price will be payable on a certain date in the future. The variable component can depend on sales or profitability.[77] (c) The acquirer can furnish a bank guarantee for the security of the payment of the purchase price. The terms of the guarantee could be that the bank must pay, if the acquirer defaults in paying the purchase price and the guarantee is claimed by the vendor.

Example: Dresdner Bank. In August 2008, Allianz SE, a large German insurance company, sold 100% of Dresdner Bank AG to Commerzbank AG for approximately €8.8 billion. The acquisition made Commerzbank Germany's largest

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[76] See Goldberg L, *op cit*, pp 214–216.

[77] See, for example, Vischer M, Earn-out Klauseln in Unternehmensverträgen, SJZ 98 (2002) pp 509–517.

retail bank by number of branches and the market leader with Mittelstand companies.

The transaction was largely in shares because of Commerzbank's concerns about maintaining sufficient levels of capital. This served a further purpose. Commerzbank's agency problems were partly mitigated because Allianz ended up with a substantial stake in the enlarged Commerzbank. The parties chose a two-step process. This helped to mitigate Commerzbank's information problems and to speed up the acquisition. In the first step, Commerzbank would acquire a bit over 60% of the Dresdner Bank and issue shares representing approximately approximately 18.4% in Commerzbank to Allianz. In step two, Dresdner Bank would be merged into Commerzbank and Commerzbank would acquire Allianz's remaining stake in Dresdner Bank. In return, Allianz would receive Commerzbank shares depending on the merger exchange ratio.

There was a cash component. In addition to a fixed component, a contigent payment was used to solve the problem of the buyer and the seller having different opinions about the valuation of Dresdner Bank's problem ABS assets. The problem assets were placed in a special vehicle. Commerzbank agreed to: take the hit on first losses on those assets of up to €275 million; put another €975 million into the vehicle to cover additional losses; and earmarked that amount (€975 million) as a contingent payment to Allianz. Only the amount not realised as losses would be paid to Allianz in 2018.

Commerzbank's share of losses from problem ABS assets was thus limited to €275 million. The maximum price payable by Commerzbank to Allianz for those assets was limited to €975 million.[78] The terms were soon renegotiated.[79]

Particular agency problems. Control over the target typically gives rise to two price-related agency problems (generally, see Volume II). Where the target is still controlled by the vendor but the parties have already agreed on the price, there is a risk of adverse changes of the target to the detriment of the acquirer. Where the target is controlled by the acquirer and the parties have agreed on a price reduction mechanism, there is a risk of adverse changes of the target to the detriment of the vendor.

In both cases, the parties may agree on covenants setting out: (a) general duties such as a duty of care, a duty to act in good faith, and a duty not to take action other than in the ordinary course of business; (b) particular duties such as restrictions on distributions of assets and changes of corporate structure; as well as (c) particular sanctions for breach of duty such as a duty to pay the agreed unadjusted price and the waiving of rights to a price reduction.

Adjustment as a sanction for misstatements. Breach of contract by the vendor can trigger various remedies under legal background rules and/or the terms of the acquisition agreement. Typically, the acquirer is entitled to damages and/or a price reduction. It is in the interests of both parties to agree explicitly on: what circumstances are regarded as breaches of contract; sanctions for breach of contract; and

[78] The last laugh, The Economist, September 2008; Commerzbank's stock exchange release of 31 August 2008.

[79] Commerzbank's stock exchange release of 27 November 2008.

the exact mechanism of price reduction or damages (a dynamic component, see Volume II).

Adjustment by virtue of the principle of equivalent treatment. In a share deal, provisions of company or securities markets law can force the acquirer to pay more to the target company's other shareholders if the acquirer pays more to all vendors of shares or at least one of them.

The adjustment of the purchase price by virtue of the principle of equivalent treatment may become necessary in three situations: when the vendors are protected by particular provisions of law; when the vendors are protected by particular regulations in the articles of association of the target; and when the offer is a public offer made for securities admitted to trading on a regulated market.

First, depending on the governing law, the price paid by the acquirer for target shares to someone can influence the price that the acquirer must pay to all holders of target shares in the context of certain transactions in which the vendors are legally forced to sell their shares. Such transactions include squeeze-out or sell-out procedures, mergers, and divisions.

Second, depending on the governing law, similar rules can be found in the target's articles of association.[80] They are sometimes used as takeover defences (section 18.4).

Third, there are particular rules on the adjustment of the price in the context of public bids. The purpose of those mandatory provisions of takeover law is to ensure the equivalent treatment of all holders of target securities of the same class.[81]

For example, where the Directive on takeover bids applies and the offeror makes a mandatory bid, the equitable price that the offeror must offer to pay is based on the highest price paid by the bidder during a certain period of time before the bid and after the bid has been made public. In the latter case, the following rule will apply: "If, after the bid has been made public and before the offer closes for acceptance, the offeror or any person acting in concert with him/her purchases securities at a price higher than the offer price, the offeror shall increase his/her offer so that it is not less than the highest price paid for the securities so acquired".[82] The provisions of the Directive on takeover bids permit Member States to authorise their supervisory authorities to adjust the equitable price provided that general principles such as the principle of equivalent treatment are respected.[83] Member States may also provide that the price already paid to target shareholders who have accepted the offer will be increased ex post where the offeror pays a higher price in the context of a mandatory bid following a voluntary bid or in the context of a squeeze-our or sell-out procedure.

Share Offers

In share offers, the adjustment of the consideration is more complicated, because a share offer basically involves the parallel acquisition of the target (in a share deal or an asset deal) and the acquisition of shares in the acquirer (the consideration).

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[80] In a German AG, however, to contents of articles of association are constrained by § 23(5) AktG ("Satzungsstrenge").

[81] Article 3(1)(a) of Directive 2004/25/EC (Directive on takeover bids).

[82] Article 5(4) of Directive 2004/25/EC (Directive on takeover bids).

[83] Article 5(4) of Directive 2004/25/EC (Directive on takeover bids).

The adjustment of the consideration can therefore depend on the circumstances of the target and the circumstances of the acquirer.

Like in a cash offer, the adjustment of the consideration can take place: at closing; after closing; or by virtue of the principle of equivalent treatment. Alternatively, the acquirer may choose to limit the adjustment of the consideration to adjustment based on mandatory provisions of law.

Valuation of the acquirer's own shares. Typically, share offers are governed by the same rules and principles as cash offers. The problem is how to apply those rules and principles to the acquirer's shares instead of cash. Whereas cash offered by the acquirer is subject to the principle of nominalism (Volume II), shares are not. The value of the acquirer's shares may fluctuate. This leads to the question how the acquirer's shares should be valued and how changes in their value should influence the adjustment of the consideration for the target or its shares.

At closing. There can be some delay between the signing of the acquisition agreement and the passing of the consideration at closing. During that period, the market price of shares can change. For this reason, a simple conversion ratio may not suffice.[84]

Adjustment by virtue of the principle of equivalent treatment. Because of valuation problems, it can be particularly difficult to apply mandatory provisions of law that provide for adjustment by virtue of the principle of equivalent treatment (see above).

Company law constraints. The adjustment of the consideration is subject to at least four further particular company law constraints in share offers and share exchanges.

First, at least in public limited-liability companies to which the Second Company Law Directive applies, the adjustment mechanism must normally be decided on or authorised by the general meeting.[85] It is therefore not sufficient to agree on an adjustment mechanism between the acquiring company and the vendor company (asset deal, share offer) or the target company's shareholders (share deal, share offer). The agreement can be conditional upon a resolution of the acquirer's the general meeting.[86]

Second, the adjustment mechanism must be compatible with the legal rules on the valuation of the object when they are used as consideration for the acquirer's shares.[87]

Third, the acquirer's shares may not be issued at a price lower than their nominal value, or, where there is no nominal value, their accountable par.[88]

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[84] For mergers in the US, see Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 175–177.

[85] Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).

[86] For the legal capital regime, see section 5.4. For counterparty corporate risk and the enforceability of such an agreement against the acquiring company, see Volume II.

[87] Article 10 of Directive 77/91/EEC (Second Company Law Directive).

[88] Article 8 of Directive 77/91/EEC (Second Company Law Directive).

Fourth, the making of any additional payments to vendors after they already have become shareholders in the acquirer can be constrained by rules on the making of distributions to the acquirer's shareholders.[89]

16.6 Buyer Due Diligence After Closing, Claims

After closing and after the acquirer has obtained control, the acquirer should find out whether the seller's warranties are complied with. This makes commercial sense, and can also be based on legal requirements.

Contract law. The acquirer should have ensured the survival of representations and warranties in the contract (sections 16.2 and 13.3.3).

Under the legal background rules, the buyer may also have a duty to inspect the object as soon as possible after closing.[90] Failure to do so can result in the buyer losing the right to invoke certain facts as breach of contract.

There may also be a statute of limitations according to which the buyer must notify the seller of breach of contract within a reasonable period of time.[91] If the buyer fails to inspect the object, the buyer may not be able to do so.[92]

Under German law, the buyer cannot invoke some remedies without setting an additional period of time (Nachfrist) for performance by the seller.[93]

Furthermore, if the buyer does not inspect the object immediately after closing, it may become more difficult for the buyer to show that there was a breach of contract at the time of closing (and that the circumstances which the buyer wants to invoke as a breach of contract did not happen after closing and after the buyer had become responsible for the object).

On the other hand, if the buyer has performed due diligence before closing and there is no reason to assume that circumstances of the object would have changed between due diligence and closing, it is possible that there is less reason to perform a similar due diligence according to good business practice and the governing law.

Contract. In order to mitigate legal risk, the parties should find out what the governing law says about these matters. The acquisition agreement often sets out the modalities for the use of indemnities including a clear last date for the making of claims under the contract.

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[89] Article 15 of Directive 77/91/EEC (Second Company Law Directive).

[90] See DCFR IV.A.–4:301 and section 31 of the Finnish and Swedish Sale of Goods Acts.

[91] See CISG Article 39; DCFR III.–3:107.

[92] See CISG Article 38.

[93] § 440 BGB. See also CISG Article 47(1).

16.7 Excursion: Auction Sale

A voluntary auction sale of shares is initiated by the vendor in co-operation with the target company, and a voluntary auction sale of assets is initiated by the vendor. It can be initiated as part of a planned search for an acquirer or after an unsolicitated offer has been received by management (see also section 10.3.2).

Advisers. The vendor's board of directors typically retains financial advisers such as an investment banking firm as well as legal advisers.

Process. Prior to commencing an auction, the vendor will have to organise the auction process and choose the auction form (section 10.3.2). For example, a closed auction can be effective even if there is only one bidder: "A bidder has no way to know whether there are other bidders, and can be expected to put forward its best bid, particularly if the process is structured to involve only a single round. In addition, the seller in a closed auction can negotiate with bidders to try to elicit higher bids."[94]

Information management. The vendor will take various steps to speed up the process. For example, the vendor will take care of time-consuming inspections such as environmental inspections, take internal corporate action, obtain permits, and so forth. A vendor due diligence will reveal questions of concern. Typically, an auction seller will engage reputable firms of outside accountants and legal counsel to prepare one or more due diligence reports covering material legal, accounting, and tax matters relating to the target business. Depending on the nature of the business, the vendor may also engage other third party consultants to provide other vendor due diligence reports such as environmental reports.[95]

As there are many bidders at the early stages of the auction process, information management will play an important role. The vendor will need to disclose enough information when searching for serious bidders. At the same time, it needs to protect its confidential information. In addition, the vendor will need to control outgoing information flows in order to manage the risk that statements made on its behalf during the auction process will add to its obligations (section 16.2) or be interpreted in an adverse way. The vendor will also have to manage the potential liability for misstatements.

It is therefore characteristic of auction sales that the vendor and its financial advisers prepare an information memorandum. The information memorandum describes the target and the auction process. The information memorandum is given to prospective bidders.

The vendor can require a commitment letter from a bank as a screening mechanism that separates serious bidders (with good prospects to raise acquisition funding) from unserious bidders (who have not been able to convince lenders). The

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[94] Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice. New York City (2008) p 170.

[95] Schmidt KM, Private Equity: Current M&A Issues for Buyers. In: PLI, Eighth Annual Private Equity Forum, Corporate Law and Practice Course Handbook Series (2007).

vendor would prefer a prospective bidder to show that its bank has given a binding promise to lend and that the prospective bidder has "certain funds".[96]

Bids, due diligenge. After prospective bidders have submitted the preliminary bids, a small number of potential acquirers will be identified and given an opportunity to conduct a due diligence review.

For this purpose, the vendor and the target prepare a data room containing documents that help bidders to verify information disclosed by the seller. Documents contained in the data room will enable prospective bidders to more rapidly focus on and address key legal and financial issues than is the case in the traditional private sale.[97] Typically, prospective bidders will be given access to vendor due diligence reports prepared by reputable external firms. Because of the nature of the auction sale, a prospective purchaser will neither be expected nor permitted to do much due diligence work of its own in the target company.[98]

Agreement. As the process is controlled by the seller, the first draft acquisition agreement typically contains just a few general warranties which are both qualified and diluted. Warranties typically are qualified by the contents of the data room. They are diluted by: high materiality thresholds; deductible baskets, caps on the liability of the seller (the lower of a percentage of the purchase price or a low fixed amount); and the expiry of rights to make claims based on warranties upon completion of the acquisition.

Finally, the vendor's or target's board will choose one of the bidders and the transaction will go forward in much the same way as in the traditional single bidder format.[99]

Example. For example, the following process is used when a seller decides to sell a real estate portfolio and contacts advisers. The same process would be used in a "share deal" or an "asset deal".

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[96] Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 2 number 22.

[97] Schmidt KM, *op cit*.

[98] *Ibid*.

[99] Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) p 174.

Table 16.2 Auction Sale. What Will the Seller Do?

First stage: Fundamental choices and time-consuming inspections	Sales material	Sales process	Final stage
Preliminary inspection of the object. Time schedule. Choice of what to sell. Choice of potential buyers. Inspection of the object, environmental inspections. Internal due diligence. Preparation of data room.	Preparation of info memo. List of tenants (this is a list of important customers). Inspection of the accuracy of information. First contacts to potential buyers, first contacts to potential sources of finance. Preparation of data room.	Info memo and the list of tenants sent to potential buyers. Preliminary bids. Choice of 2–3 potential buyers. First draft purchase contract sent to potential buyers. Preparation of data room completed.	Data room / buyers' due diligence. Potential buyers visit the object. Negotiations, drafting of the purchase contract. Final and binding bids. Drafting of last details + signing of the purchase contract.

Table 16.3 Auction Sale. Why Will the Seller Do It?

The seller wants to avoid negative surprises	Potential buyers are given all information that may influence the value of the object	Potential buyers are given an opportunity to verify the truthfulness of information
The seller verifies the information that will be given to potential buyers. Environmental inspections are time-consuming. Data room is a place that contains documents (or computer files) that help the buyer to verify the truthfulness of information provided by the seller.	Information memorandum contains important information for bidders about the object and the auction process.	Potential buyers inspect documents; they do not inspect the object. Only serious bidders may perform due diligence.

17 Duties of the Board in the Context of Takeovers

17.1 General Remarks

Business acquisitions raise questions about board members' duties. For example, in whose interests should board members act according to general company law rules? Do members of the target's board have a duty to be "neutral" in the context of acquisitions? Do members of the target's board have a right or duty to use takeover defences, or are takeover defences prohibited?

Generally, there can be different views about the nature of directors' duties (a duty to act or a right to act), the party whose interests board members should further (for example, a duty to act in the interests of shareholders, the company, or the firm), and the content of those duties.[1]

17.2 In Whose Interests Shall Board Members Act?

According to general company law rules, members of the board have a duty to act in the interests of the company. While this question can be problematic in all companies (see Volume I), it is even more problematic in the target company especially where the target company's shares have been admitted to trading on a regulated market.

Effect of takeover bid on share price. The price that investors are prepared to pay for shares in a company with dispersed ownership is adversely affected by agency costs as well as on legal constraints on distributions. The market pricing of shares can change when someone tries to acquire all shares in the company. Because of the legal and de facto powers of a sole shareholder, the buyer of all shares in the company can pay a higher price per share. For this reason, an expected takeover bid for all shares can trigger a "quantum leap" of the share price. The failure of a bid can cause the share price to sink to previous levels immediately.

The failed takeover bid for Yahoo! (see Volume I) is an example of such a price change. In 2008, Microsoft made a hostile takeover bid for this Californian corporation. Microsoft's

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[1] It is therefore not just a question of the extent of those duties. Compare Merkt H, Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen, ZHR 165 (2001) p 225.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
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final offer for Yahoo! was about $47.5 billion and some 70% more than Yahoo!'s market valuation at the time of the opening bid. The board of Yahoo! nevertheless rejected the bid. This reduced the market valuation of Yahoo! to $34 billion.

No board neutrality in the US. According to Delaware law, the board of the target has no legal duty to be neutral or accept the bid. The target's board may say no. So long as the board acts on a fully informed basis, the board is be protected by the business judgment rule.[2]

Judicial review of directors' actions may be enhanced in certain circumstances including defending against a change of control or engaging in a sale of control. The adoption of defensive mechanisms (other than the just-say-no defence) must satisfy the *Unocal* standard (see Volume I).[3] If the Unocal standard is satisfied, the directors again benefit from the business judgment rule. The Unocal standard can be called a qualified business judgment rule.[4]

If the directors indeed have decided to sell control of the company, their actions will be constrained by the *Revlon* test.[5] The Revlon test means that "[t]he directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company".[6]

When Revlon duties apply, a board's conduct will be evaluated by review of both its process and its result. As a consequence, a board engaging in a change-of-control transaction must establish basic procedures to preserve the integrity of its evaluation of the options that may arise. One critical element is to ensure that only disinterested directors evaluate and vote on the proposed transaction. Typically, a special committee might be formed. The function of a special committee is to protect shareholder interests in cases where the interests of management directors or other interested directors differ significantly from those of the shareholders. In several cases, Delaware courts have been skeptical of processes that did not involve the active participation of special committees.[7]

Finally, the most exacting standard is the "entire fairness" review. It may apply in transactions involving a conflict of interest.[8] This means that going-private transactions (such as LBOs, MBOs, and private-equity deals) that will go through are evaluated by the strictest "entire fairness" standard. The board of directors has a duty to prove that both the going-private process it followed and the price it obtained were entirely fair under the circumstances.

No board neutrality under Community law. Similar rules apply in Europe. The board of the target company does not have any general legal obligation to be "neu-

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[2] See Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice. New York City (2008) p 43, citing, for example: Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987); and Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360–61 (Del. 1993) ("Technicolor").

[3] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 946 (Del. 1985).

[4] See, for example, Merkt H, Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen, ZHR 165 (2001) p 235.

[5] Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d at 173 (Del. 1986).

[6] Paramount Communications Inc. v. QVC Network, Inc., 637 A.2d at 46.

[7] Cole J Jr, Kirman I, *op cit*, pp 76–79.

[8] *Ibid*, pp 43–50.

tral". The main company law rule is that board members must act in the interests of the company whether or not the company has become a takeover target. There is no such thing as a general company law duty of "board neutrality" in the context of takeovers. Neither is there any general company law duty to maximise the price that shareholders can get for their shares. Apart from the Directive on takeover bids, Community law has not explicitly addressed the question in whose interests the target's board should act in the context of an unsolicited bid, and the Directive on takeover bids does not lay down any board duty to remain neutral or passive in front of a takeover bid.[9]

The purpose of the Directive on takeover bids is to "establish minimum guidelines for the conduct of takeover bids and ensure an adequate level of protection for holders of securities throughout the Community".[10]

According to the general principles set out in Article 3 of the Directive, "the board of an offeree company must act in the interests of the company as a whole".[11] Where it advises the holders of securities, "the board of the offeree company must give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company's places of business".[12] For this purpose, "[t]he board of the offeree company shall draw up and make public a document setting out its opinion of the bid and the reasons on which it is based, including its views on the effects of implementation of the bid on all the company's interests and specifically employment, and on the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the company's places of business".[13] Furthermore, "all holders of the securities of an offeree company of the same class must be afforded equivalent treatment". If a person acquires control of a company, "the other holders of securities must be protected".[14]

This means that the Directive on takeover bids forces Member States to ensure that the target's board has a duty to act in the interests of the company as a whole. Those interests include "all the company's interests".

The Directive does not clearly distinguish between the interests of stakeholders and the firm's own interests. "All the company's interests" include as a minimum requirement at least:[15] the interests of the company's stakeholders, in particular the interests of employees; the interests of the target's other shareholders to take decisions in an informed way; the interests of all shareholders to receive equivalent treatment; and the interests of minority shareholders to exit the target where the bidder has obtained control.

The Directive nevertheless recognises the interests of the firm as worthy of protection. The Directive protects: the interests of an offeree company as a whole;[16] the interests of an

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[9] The popular view is that it does lay down such a board duty. See, for example, Mucciarelli FM, White Knights and Black Knights - Does the Search for Competitive Bids Always Benefit the Shareholders of "Target" Companies? ECFLR 3 (2006) pp 408–425 at p 409.

[10] Recital 25 of Directive 2004/25/EC (Directive on takeover bids).

[11] Article 3(1)(c) of Directive 2004/25/EC (Directive on takeover bids). According to German law, the management board and the supervisory board of the target company must act in the interests of the target company. § 5(3) WpÜG.

[12] Article 3(1)(b) of Directive 2004/25/EC (Directive on takeover bids).

[13] Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).

[14] Article 3(1) of Directive 2004/25/EC (Directive on takeover bids).

[15] Article 3(2) of Directive (Directive on takeover bids).

[16] Article 3(1)(c) of Directive 2004/25/EC (Directive on takeover bids).

offeree company not unnecessarily to be hindered in the conduct of its affairs;[17] and the interests of an offeree company to take action in the ordinary course of its business.[18]

The Directive does not explicitly set out any ranking for the company's different interests (the interests of the firm and the interests of its various stakeholders) or lay down their relative weights. Neither does the Directive lay down any duty to recommend a particular bid or the grounds for refusing to recommend a bid. The board may say no, provided that it discloses the reasons on which its opinion is based.[19] The board may also seek alternative bids.[20]

Although the Directive leaves many questions open, the wording of the Directive implies that the target's board must not have a duty to get the best price for shareholders at the cost of the interests of the target's (other) main stakeholders.

Furthermore, the Directive on takeover bids does not restrict the board's general duty of care and fiduciary duties. Those duties are typically owed to the company rather than to any particular shareholder or shareholders in general. Delaware law shows that there is no reason to adopt fundamentally different duties of care or fiduciary duties when somebody makes an unsolicited offer for the company. Being a target is a normal situation in the life of a company, and the normal duties of care and fiduciary duties should apply. New duties of care and fiduciary duties should be adopted only for an important reason.[21] In Delaware, they are applied only after the board already has accepted a change of control (the Revlon test).

The Directive on takeover bids thus does not require the target's board to be neutral. The general principle of equivalent treatment of shareholders[22] does not mean the equivalent treatment of the interests of existing shareholders and those of potential shareholders.[23] The board has a duty to take certain interests into account. The board's general duty of care and fiduciary duties apply.

Frustration and Community law. The duty of the target's board to act in the interests of the company might nevertheless be constrained by particular provisions of law.[24] According to Community law, the target's board can have a limited duty not to frustrate a public takeover bid depending on the governing law.

The Directive on takeover bids does not prohibit the target from frustrating the bid. Instead, the Directive sets out how corporate action which may result in the frustration of the bid must be decided on.[25] The provisions of the Directive on frustating the bid are optional for the Member States and can be optional for target companies depending on the governing law.[26]

This can be illustrated by German law. § 33(1) WpÜG prohibits the target's management board from taking "any actions which could prevent the success of

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17 Article 3(1)(f) of Directive 2004/25/EC (Directive on takeover bids).
18 Article 9(3) of Directive 2004/25/EC (Directive on takeover bids).
19 Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).
20 Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).
21 See, for example, Merkt H, Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen, ZHR 165 (2001) p 226.
22 Article 3(1)(a) of Directive 2004/25/EC (Directive on takeover bids).
23 See also Merkt H, *op cit*, p 247.
24 See, for example, *ibid*, p 225.
25 Articles 9(2) and 9(3) of Directive 2004/25/EC (Directive on takeover bids).
26 Article 12 of Directive 2004/25/EC (Directive on takeover bids).

the offer" during a certain period of time. However, the WpÜG does not really prohibit those actions, because § 33(1) WpÜG sets out that those actions can be taken with the consent of the supervisory board. § 33(2) WpÜG provides how they can be taken with the consent of the general meeting. The company can opt out of § 33 WpÜG in its articles of association, in which case a slightly stricter statutory regime under § 33a WpÜG will apply.

It is not the purpose of the Directive to hinder the company when it carries on its normal business activities. Exceptional rules on the internal decision-making of the company apply only to actions of an exceptional nature.[27]

The Directive explicitly sets out that the board may seek alternative bids (the White Knight defence) without the consent of the general meeting.[28]

During a certain period of time, the general meeting may have a special controlling function and a veto right. Apart from seeking alternative bids, the board may not take any action which may result in the frustration of the bid, unless it obtains the prior authorisation of the general meeting. With the consent of the general meeting, even other ways to frustrate the bid are thus permitted.[29] This makes possible to combine the duty of the board to "act in the interests of the company as a whole" and the right of shareholders to "decide on the merits of the bid" in two ways, namely by authorising takeover defences (usually) by a simple majority or by selling shares individually.[30] The transparency of the board's actions is increased through provisions on the duty to disclose a document setting out its opinion.[31]

On the other hand, those legal constraints are optional. The Directive does not require Member States to adopt provisions on the frustration of the bid so long as companies within those Member States are allowed to opt in to them on a company-by-company basis.[32]

In addition, Member States are allowed to enact legislation exempting target companies from those rules in the event of bids by companies that are not themselves subject to them. If applied, this exemption can be used to the detriment of bidders from other Member States that refuse to adopt the frustration rules and to the detriment of US and other non-European bidders.[33] The result of this "reciprocity clause" is that companies from a takeover-friendly country can more easily be taken over by domestic companies than by companies from a country which allows greater board activism. There are doubts about the legal basis of this exemption. It is an established rule of Community law that any discrimination against a company from another Member State is prohibited.[34]

[27] Recital 16 and Article 3(1)(f) of Directive 2004/25/EC (Directive on takeover bids).
[28] Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).
[29] Articles 9(2) abd 9(3) of Directive 2004/25/EC (Directive on takeover bids).
[30] See Article 3(1)(c) of Directive 2004/25/EC (Directive on takeover bids).
[31] Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).
[32] Articles 12(1) and 12(2) of Directive 2004/25/EC (Directive on takeover bids).
[33] Article 12(3) of Directive 2004/25/EC (Directive on takeover bids).
[34] Siems MM, SEVIC: Beyond Cross-Border Mergers, EBOLR 2007 p 316: "As a result, in order to be in conformity with the freedom of establishment, a rule would have to require that the takeover-friendly law is applicable unless the company opts out of it."

17.3 Duty to Obtain Advice or to Give Advice

Requirements as to the substance of opinions or independent advice in the context of public takeover bids can reflect the choice of principal and agent under the legal framework. There is a difference between the position of Community law and the position of English law.

Community law. As said above, the offeror company must "draw up and make public … an offer document containing the information necessary to enable the holders of the offeree company's securities to reach a properly informed decision on the bid".[35] For example, the offer documents must state "the offeror's intentions with regard to the future business of the offeree company and, in so far as it is affected by the bid, the offeror company" as well as "the offeror's strategic plans for the two companies".[36]

The board of the offeree (target) company must "draw up and make public a document setting out its opinion of the bid and the reasons on which it is based, including its views on the effects of implementation of the bid on all the company's interests and specifically employment, and on the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the company's places of business".[37]

The Directive does not require the boards to obtain independent advice. Neither does it require the board of the target to say whether the bid is in the interests of shareholders.

English law. In England, the board of the target company must take competent independent advice on the offer and communicate the substance of the advice received to the shareholders.[38] The board of the offeror company has a duty to obtain independent advice when the directors are faced with a conflict of interest; in that case, the "advice should be as to whether or not the making of the offer is in the interests of the company's shareholders".[39] One can therefore draw the conclusion that shareholders of both companies expect to be told whether the proposed transaction is in their interests (for the dominance of institutional shareholder, see below).

Role of the board. The duty to disclose information to shareholders raises questions about the role of the board as an information intermediary.

The target's board cannot be a reliable source of information about the value of the acquirer's shares offered as consideration in a proposed transaction. First, there is not enough "proximity" to the "information target" (they do not know enough of the acquirer, see Volume I). Second, there is not enough proximity to the "information topic" (they do not know enough of valuation issues in general as they are not valuation specialists in their capacity as board members). Third, from a legal perspective, there is a very large "tolerance zone" for statements about the

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35 Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).

36 Article 6(3)(i) of Directive 2004/25/EC (Directive on takeover bids).

37 Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).

38 Rules 3(1) and 15(1) of the City Code on Takeovers and Mergers.

39 City Code on Takeovers and Mergers, Notes on Rule 3.2.

valuation of a company (flexibility of law, Volume II). For statements by the board, the business judgment rule applies.[40]

In the target company, the board is a competent information intermediary only in matters that relate to the target firm itself. The target's board can say something about the target firm's own future prospects and about the industrial logic behind the offer. The target's board may have information about how much debt the target company can be expected to bear. However, the target's board is not an expert on the future valuation of the target company's shares (or the future valuation of the acquirer's shares).

In the offeror company, the board is a competent information intermediary in matters that relate to the offeror firm itself and its plans for the combined firm. The offeror's board knows about the offeror firm's own future prospects and can say something about the industrial logic behind the offer. However, the offeror's board is not an expert on the future valuation of the acquirer's shares (or the future valuation of the target company's shares should the target company remain independent).

This can help to explain why, under the Directive on takeover bids, the offeror and the board of the target company, in effect, have a duty to give their views about the industrial logic of the proposed takeover but no duty to say whether the takeover would be in the interests of shareholders.

This is understandable also in the light of the fact that real shareholders have different interests, their real interests may conflict with those of the firm, and fictive shareholders do not exist. A real shareholder may or may not benefit from what is in the "interests of the company as a whole"[41] or what makes industrial sense for the target firm. Whether fictive shareholders benefit from those decisions depends on what interests those fictive shareholders are supposed to have.

In any case, as shareholders are free to sell their shares, the target company relies on its shareholders as agents to decide on the valuation of its shares, the acceptance of the offer, and changes in its ownership structure.[42] It should belong to the tasks of the target's board to try to convince shareholders to act according to what can benefit the firm.

Advice on whether the bid is in the interests of shareholders can better be given by an independent adviser rather than the target's board.

This is also the position of the City Code which regulates public takeovers in England. The English position is nevertheless influenced by the dominance of institutional investors as regulators, the dominance of a different ideology which focuses on the maximisation of the wealth of those institutional shareholders, and therefore also the dominance a different principal-agency relationship. According to that ideology, there is a fundamental conflict between the target's shareholders whose wealth should be maximised (the shareholder

[40] For Delaware law, see Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice. New York City (2008) pp 82–85.

[41] Article 3(1)(c) of Directive 2004/25/EC (Directive on takeover bids).

[42] Article 3(1)(b) and (c) of Directive 2004/25/EC (Directive on takeover bids).

agent hypothesis) and its managers who only want to remain in control (the management entrenchment hypothesis).[43]

17.4 Takeover Defences and the Interests of the Firm

The share ownership structure of the firm belongs to the strategic choices the firm's survival depends on. In addition, managing the firm's debt-to-equity ratio is one of the most important ways to manage the firm's risk level. A takeover can change both. A takeover results in a new share ownership structure. Takeovers tend to result in high leverage, because takeovers like LBOs are typically financed from the cash-flow of the target (Chapter 20).

From the perspective of the firm, the use of takeover defences is a legitimate way to manage its share ownership structure and leverage, and to protect its corporate strategy. In short, it is a legitimate form of corporate risk management.

The target's board can weigh the costs and benefits of the potential takeover, the costs and benefits of using takeover defences (for takeover defences, see Chapter 18), and the costs and benefits of permitted financial assistance (for financial assistance, see section 20.4). (a) For example, the firm might benefit from having a certain controlling shareholder in some respects (for the function of shareholders, see Volume I). On the other hand, the benefits do not necessarily outweigh the cost of increased indebtedness (in an LBO, the target will end up repaying the loans) and the increased cost of equity capital (some acquirers like private-equity funds require large distributions). (b) It is also possible that the firm can achieve the same benefits without changing its existing share ownership structure. For example, the firm can choose its optimal debt-to-equity level. (c) The target's board can also choose to reduce the cost of the takeover by causing the company to give permitted financial assistance when the board believes that it is in the interests of the firm to do so (section 20.4).

The legitimacy of the firm's interest to use takeover defences has been recognised not only in Delaware where the *Unocal* standard applies, but also in Community law (but neither in the London market nor in legal science).

As explained above (section 17.2 and Volume I), the duty to further the interests of the firm belongs to the most important duties of the board. The corporate bodies of the firm are expected to decide what to organise internally and when to rely on the markets.[44] Possibly apart from the situation when the *Revlon* test applies,[45] there is no reason to disapply the general rules on directors' duties just because somebody wants to take over the company or its business.[46] The board

43 See, for example, Barboutis GO, Takeover Defence Tactics: Part I: The General Legal Framework on Takeovers, Comp Lawyer 20(1) (1999) pp 14–22.

44 Coase R, The Nature of the Firm, Economica, New Series, Vol. 4, No. 16 (Nov. 1937) pp 386–405.

45 Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d at 173 (Del. 1986).

46 See also Merkt H, Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen, ZHR 165 (2001) pp 225 and 245.

should never be "neutral", and it is simply wrong to assume that the board of the target has a duty to remain passive in front of a takeover bid under the Directive on takeover bids (see above).

Community law. In *Commission v Netherlands*,[47] the eighth ruling in the series of golden shares judgments, the ECJ indicated that the organs of the company should be concerned about what is in the company's interests (rather than other interests).[48] The ECJ also identified a price mechanism that can make legal rules and administrative practices that override this principle incompatible with the provisions of the EC Treaty on the free movement of capital.[49]

According to the ECJ, national measures can be regarded as restrictions on the free movement of capital "if they are likely to prevent or limit the acquisition of shares in the undertakings concerned or to deter investors of other Member States from investing in their capital".[50]

The ECJ said that the possible refusal by the Netherlands State (a controlling shareholder by virtue of a special share) to approve an important decision, proposed by the organs of the company concerned as being in the company's interests, is capable of depressing the stock market value of the shares of the company. This can reduce the attractiveness of an investment in the company's shares.[51] When the proposed transaction is a control transaction, the existence of a special share may have a negative influence on direct investments (by making questions of merger, demerger and dissolution depend on the prior approval of the Netherlands State).[52] Generally, if the existence of a special share makes investments in the company's shares less attractive, it will also have a deterrent effect on portfolio investments.[53] The ECJ thus distinguished between direct investments and portfolio investments[54] and held that both are relevant.

In the light of Commission v Netherlands, legal rules and administrative provisions that enable a shareholder "to pursue interests which do not coincide with the economic interests of the company concerned might discourage direct or portfolio investments in that company"[55] and amount to a restriction on the free movement of capital under Article 56(1) of the EC Treaty, unless those restrictive effects are either too uncertain or too indirect to constitute an obstacle to the free movement of capital.[56]

On the other hand, the ECJ did not distinguish between the pursuing of interests which coincide with the economic interests of the company (such as the long-term survival of the firm) and actions that increase share price (such as short-term ac-

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[47] Joined Cases C-282/04 and C-283/04 Commission v Netherlands [2006] ECR I-9141. Generally, see Looijestijn-Clearie A, All That Glitters Is Not Gold: European Court of Justice. Strikes Down Golden Shares in Two Dutch Companies, EBOLR 2007 pp 429–453.

[48] Commission v Netherlands, *ibid*, paragraph 27.

[49] Article 56(1) of the EC Treaty.

[50] Commission v Netherlands, paragraph 20.

[51] Commission v Netherlands, paragraph 27.

[52] Commission v Netherlands, paragraph 26.

[53] Commission v Netherlands, paragraph 27.

[54] Commission v Netherlands, paragraph 19.

[55] Commission v Netherlands, paragraph 28.

[56] Commission v Netherlands, paragraph 29.

tions designed to increase share price regardless of whether they are in the long-term interests of the firm). Because of the effect of takeover bids on share price (see above), the ECJ thus left room for a competing ideology.

Competing ideology. The supporters of a competing ideology argue that there are several economic and legal reasons to limit the use of defensive tactics. Legal rules should maximise the wealth of the target's shareholders. Defensive tactics are said to distort the market for corporate control, which according to many writers should be "free". For example, Easterbrook and Fischel have said that target management should refrain from defensive tactics and leave the decision of whether to sell solely to the shareholders.[57] According to Bebchuk[58] and Gilson,[59] the target directors should be allowed to solicit rival bids as well as engage in propaganda but do nothing more.

German law. Such views have been expressed even in Germany. Many German writers say that the management board should be "neutral".[60]

On the other hand, there are other views[61] and judgments that are clearly based on the assumption that the management board does *not* have a general duty of neutrality. In the *Mannesmann/Vodafone* case,[62] the Düsseldorf appeals court (Landgericht) held that marketing actions such as roadshows belonged to customary management actions which did not breach any duty to be neutral in the context of a takeover bid. Under German law, the management board is generally permitted to convince shareholders of what shareholders according to the board's opinion should do, and to build a shareholder coalition against the bid.[63]

English law. As far as listed companies are concerned, the position of English laws is much more restrictive than the position of Community law and the position of German or US law. Whereas the business judgment rule gives management a nearly unfettered ability to implement defensive action under Delaware law, defensive action is tightly restrained for companies listed in London.

The Takeover Code reflects the dominance of institutional shareholders who dislike the adoption of defensive devices by the management of potential takeover

[57] Easterbrook FH, Fischel DR, The Proper Role of Target Management in Responding to a Tender Offer, Harv L R 94 (1981) pp 1161–1208. See also Auctions and Sunk Costs in Tender Offers, Stanf L R 35 (1982) pp 1–21.

[58] Bebchuk LA, The Case for Facilitating Competing Tender Offers, Harv L R 95 (1982) pp 1028–1056.

[59] Gilson RJ, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, Stanf L R 33 (1981) pp 819–891.

[60] See in particular Hopt KJ, Aktionärskreis und Vorstandsneutralität, ZGR 1993 pp 534–566. See also Merkt H, Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen, ZHR 165 (2001) pp 234 and 256.

[61] Paefgen WP, Unternehmerische Entscheidungen und Rechtsbindung der Organe in der AG. Verlag Dr. Otto Schmidt, Köln (2002) p 339: "Maßgeblich kann vielmehr allein der Gesichtspunkt der Optimierung des Einsatzes der ökonomischen Ressourcen des von der Gesellschaft betriebenen Unternehmens sein."

[62] LG Düsseldorf, judgment of 14.12.1999 (10 O 495/99 Q).

[63] See Merkt H, Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen, ZHR 165 (2001) p 248; Maier-Reimer G, Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen, ZHR 165 (2001) pp 263–264.

> targets. The Code is strongly weighted toward protecting the interests of shareholders. Unless shareholders consent, the Code strictly prohibits management from employing any defensive tactics that would have the effect of frustrating an actual or anticipated bid. In contrast, management in the US has a good deal more flexibility to engage in defensive tactics, provided that these can be justified in accordance with their fiduciary duties.[64]

The detailed restrictions are based on the City Code on Takeovers and Mergers (for its scope, see section 19.1) rather than case-law. The case-law is still unclear.

The case of *Cayne v Global Natural Resources plc* might suggest that the "just say no" defense could be available under English law.[65]

In the case of *Criterion Props. plc v Stratford U.K. Props. LLC*,[66] Lord Justice Carnwath suggested that a lock-up might be justifiable in the face of a hostile acquirer who threatened the company's existing business, but felt that the arrangement in question was disproportionate in its response to the perceived threat. This formulation is strikingly similar to the proportionality test employed by Delaware courts in reviewing directors' conduct under *Unocal*.

In *Howard Smith Ltd v Ampol Petroleum Ltd*, Lord Wilberforce said: "… it must be unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist … Directors are of course entitled to offer advice, and bound to supply information, relevant to the making of such a decision, but to use their fiduciary power solely for the purpose of shifting the power to decide to whom and at what price shares are to be sold cannot be related to any purpose for which the power over the share capital was conferred upon them."

In *Heron International Ltd v Lord Grade*,[67] the Court of Appeal declared in a dictum that: "Where directors have decided that it is in the best interests of a company that the company should be taken over and there are two or more bidders the only duty of the directors … is to obtain the best price."[68] This view resembles the position of Delaware law under which with the business judgment rule is combined with the *Revlon* test.

In *Re a Company*,[69] Hoffmann J however refused to accept "the proposition that the board must inevitably be under a positive duty to recommend and take all stepts within their power to facilitate whichever is the highest offer".

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[64] Davies PL, Gower and Davies' Principles of Modern Company Law, Seventh Edition. Sweet & Maxwell, London (2003) p 750; Armour J, Skeel DA Jr, Who Writes the Rules for Hostile Takeovers, and Why? – The Peculiar Divergence of U.S. and U.K. Takeover Regulation, Georgetown L J 95 (2007) pp 1727–1794; Ogowewo TI, The Underlying Themes of Tender Offer Regulation in the United Kingdom and the United States of America, JBL 1996 pp 479–481.

[65] Criterion Props. plc v. Stratford U.K. Props. LLC, [2002] EWCA (Civ) 1783, [2003] 1 WLR p 2108 quoting Cayne v. Global Res. plc (unreported decision of Sir Robert Megarry, V.C., 12 August 1982). See Armour J, Skeel DA Jr, ibid, pp 1783–1784, footnote 267.

[66] Criterion Props. plc v. Stratford U.K. Props. LLC, [2002] EWCA (Civ) 1783, [2003] 1 WLR 2108.

[67] Heron International Ltd v Lord Grade [1983] BCLC 244 (Court of Appeals).

[68] See Davies PL, Gower and Davies' Principles of Modern Company Law, Seventh Edition. Sweet & Maxwell, London (2003) p 719.

[69] Re a Company [1986] BCLC 382.

Generally, the board of the target company must take competent independent advice on the offer and communicate the substance of the advice received to the shareholders.[70]

Rule 21 of the City Code seeks to ensure shareholder sovereignty by setting out restrictions on frustrating action. It sets out a general restriction which starts to apply during the pre-bid period. Where the board of a company has reason to believe that a bona fide offer might be imminent and during the course of the offer, the board must not, without the consent of shareholders in general meeting, "take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits".[71] In case of doubt, the Panel must be consulted in advance.

In addition to a general restriction, the City Code lists a number of particular forms of frustrating action to which the restrictions apply.[72]

There are particular rules on inducement fees.[73] First, the Takeover Panel should be consulted at the earliest opportunity in all cases where an inducement fee or any similar arrangement is proposed. Second, in all cases where an inducement fee is proposed, certain safeguards must be observed. In particular, an inducement fee must be de minimis (normally no more than 1% of the value of the offeree company calculated by reference to the offer price). Third, the target's board and its financial adviser must confirm to the Panel in writing that they each believe the fee fo be in the best interests of shareholders. There are also rules on disclosure of inducement fees.

There are constraints on share purchases by the target. Rule 37.3 of the City Code requires shareholder approval before the target redeems or purchases its own shares either during the course of an offer or the pre-bid period when the board has reason to believe that an offer is imminent.[74] There are also rules on disclosure.

Rule 20 of the City Code requires equality of information given to competing bidders. Rule 20 prevents a target company from giving a preferred bidder an unfair advantage by furnishing it with information, thereby making it more difficult for a less favoured suitor to compete - with the result that target shareholders may be deprived of a better offer.[75]

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[70] Rules 3(1) and 15(1) of the City Code on Takeovers and Mergers.

[71] Rule 21.1 of the City Code on Takeovers and Mergers.

[72] Rule 21.1 of the City Code on Takeovers and Mergers.

[73] Rule 21.2 of the City Code on Takeovers and Mergers.

[74] Rule 37.3(a) of the City Code on Takeovers and Mergers. See also Notes 1 and 5 on Rule 21.1.

[75] Rule 20.2 of the City Code on Takeovers and Mergers.

18 Takeover Defences

18.1 General Remarks

The target's board of directors functions as a "gatekeeper" in all acquisitions which require the consent of the target. Mergers, asset deals, and reverse takeovers are always friendly. A potential acquirer can circumvent such constraints by making an offer directly to the target's shareholders contrary to the intentions of the target's board. Particular takeover defences are designed to reduce the risk of such offers.[1]

Three main methods. Generally, takeover defences work in three main ways. First, they can make the acquisition of a sufficient amount of shares more expensive or impossible. Second, they can reduce the rights attached to shares or restrict their exercise. Third, they can frustrate the commercial purpose of the acquisition.

Categories. Takeover defences are usually divided into various categories. The two main categories of takeover defences are pre-bid defences (structural defences, control enhancing mechanisms) and post-bid defences. Some takeover defences belong to both categories at the same time.

It is sometimes distinguished between takeover defences that apply to the "external" and "internal" market for corporate control.[2] On the other hand, those markets for corporate control are, to a large extent, interrelated.

A person can be said to have full control over a corporate firm (subject to problems relating to agency relationships in general) when that person can decide how the board must act and the board tries to further the interests of that person. Typically, the voting power of a very large blockholder will also ensure a high degree of control over the board. There are nevertheless "internal" takeover defences that seek to shield the board from new blockholders.

Pre-bid defences. According to the Report of the High Level Group of Company Law Experts,[3] pre-bid defences include:

- the use of direct barriers to the acquisition of shares in the target;
- the use of barriers to exertion of control at the general meeting;
- the use of barriers to exertion of control in the board of directors;

[1] Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) p 312.
[2] For those two markets for corporate control generally, see Manne HG, Mergers and the market for corporate control, J Pol Econ 73 (1965) pp 110–120.
[3] Commission of the European Communities, Report of the High Level Group of Company Law Experts on Issues related to Takeover Bids, 10 January 2002.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
DOI 10.1007/ 978-3-642-03058-1_18, © Springer-Verlag Berlin Heidelberg 2010

- the use of barriers to exertion of control over the assets of the target;
- the creation of financial burdens as a consequence of the transfer of control; and
- the creation of regulatory problems.

Structural takeover defences. Most pre-bid defences can also be called structural takeover defences. The Directive on takeover bids requires each company whose shares have been admitted to trading on a regulated market to disclose in its annual report certain information that enables investors to assess the existence of structural takeover defences.[4] In addition, the board has a duty to present an explanatory report to the annual general meeting of shareholders on such matters.[5]

Control enhancing mechanisms. Most structural takeover defences function by enhancing blockholders' control over the company. They can thus be called "control enhancing mechanisms" (for blockholding as a corporate governance tool, see Volume I). Another Report commissioned by the European Commission[6] divides control enhancing mechanisms into three main categories:

- mechanisms allowing blockholders to enhance control by leveraging voting power;
- mechanisms used to lock in control; and
- other mechanisms.

Mechanisms allowing blockholders to enhance control by leveraging voting power include the use of: shares with multiple voting rights; non-voting shares; non-voting preference shares; and pyramid structures.

Mechanisms used to lock in control include: priority shares; depository certificates; voting right ceilings; share transfer restrictions; and supermajority provisions.

Other mechanisms include the use of: partnerships limited by shares; golden shares; cross-shareholdings; and shareholders' agreements.

Post-bid defences. The Report of the High Level Group of Company Law Experts also identified the following post-bid defences:

- reducing the amount of shares that can be acquired by the bidder;
- increasing the cost of the bid; the creation of regulatory problems;
- the search for an alternative bidder (the White Knight defence);
- the acquisition of the bidder's interest in the company (the Greenmail defence); and
- making a bid for bidder shares (the Pacman defence).

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[4] For a detailed list of structural takeover defences, see Article 10(1) of Directive 2004/25/EC (Directive on takeover bids).

[5] Article 10(3) of Directive 2004/25/EC (Directive on takeover bids).

[6] Report on the Proportionality Principe in the European Union, 18 May 2007. It was prepared by Institutional Shareholder Services, the European Corporate Governance Institute, and Shearman & Sterling LLP.

Pre-bid and post-bid defences. Some types of takeover defences can be used both before the making of the bid and after the bid has been made. For example, the costs of the bid can be increased by reducing the amount of assets that can be used to refinance the bid after the completion of the acquisition, and tactical litigation can be used as a defence both before and after the making of the bid.

Main legal constraints. Regardless of the method, the availability of takeover defences is constrained by mandatory provisions of company law (and may be constrained by provisions of securities markets law). Pre-bid and post-bid defences are basically subject to the same legal constraints. The main constraints are:

- the purpose of the company;
- the principle of equivalent treatment of shareholders;
- the European legal capital regime which restricts the making of distributions to shareholders;
- the fact that the existing regulations of the articles of association and their amendment must not breach mandatory provisions of company law; and
- the fact that the amendment of articles of association must be decided on by shareholders at general meeting.

The most striking difference between the US and the EU is that the right of the target's board to decide on the issuing of shares and share buybacks is constrained by the Second Company Law Directive and subject to shareholder consent.[7] Generally, large differences in the company law regulation of corporate governance mean that different kinds of takeover defences will be used depending on the governing law.[8] Share ownership structure will also play a major role: "proxy fights" are rarely relevant in the European takeover market.

The purpose of the company and the purpose of the transaction. Many takeover defences are value-destroying in nature. This is one of the reasons why US-type poison pills and the Pac-Man Defence are rare in Europe. The use of value-destroying takeover defences is not in line with the prevailing shareholder value culture.

In addition, transactions that are designed to be value-destroying are likely to fall outside the purpose of the company and be "ultra vires" in many countries. Their use will also be constrained by mandatory company law provisions under which corporate actions must be taken for a proper purpose. Value-destroying

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[7] For a comparison of UK law and US law, see Barboutis GO, Takeover Defence Tactics: Part 2 - Specific Defensive Devices, Comp Lawyer 20(2) (1999) pp 40–49.

[8] For defences used under Delaware law, see Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice. New York City (2008) pp 96–122.

transactions can also trigger the personal liability of board members for damage sustained by the company, or, less often, by shareholders and third parties.[9]

18.2 Pre-Bid Defences Well in Advance

The starting point is that it is legally easier to take pre-bid measures well in advance of a takeover offer. (a) Pre-bid measures which have been decided on and fully implemented before the bid was made public or the board became aware that the bid was imminent[10] are less likely to be constrained by mandatory provisions of law. (b) In a listed company, takeover defences which have not yet been fully implemented before that point of time are subject to more constraints under the Directive on takeover bids. In that case, "the general meeting of shareholders shall approve or confirm any decision which does not form part of the normal course of the company's business and the implementation of which may result in the frustration of the bid".[11]

18.3 Structural Takeover Defences, Control

Structural defences and control enhancing mechanisms are pre-bid takeover defences which act as barriers to the acquisition of shares in the target[12] or barriers to exertion of control at the general meeting.[13] They are very widespread in Europe. Most of them have already been discussed in Volume I in the context of blockholding.

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9 See Becker D, Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen, ZHR 165 (2001) pp 281–282; Maier-Reimer G, Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen, ZHR 165 (2001) p 265.

10 Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).

11 Article 9(3) of Directive 2004/25/EC (Directive on takeover bids).

12 The Report of the High Level Group of Company Law Experts identified the following barriers to the *acquisition* of shares in the target: ownership caps; "golden shares"; restrictions to the transferability of shares (applicable to non-listed shares; listed shares may be subject to limitations in shareholders' agreements); lack of access to the underlying shares (where depository receipts are traded instead of underlying shares); the dilution of the shares acquired by the bidder or potential bidder (poison pills, certain classes of poison debt); and the reduction of available shares by means of: acquisition of own shares, cross-shareholdings, or pyramiding.

13 The Report of the High Level Group of Company Law Experts identified the following barriers to the exertion of *control* at the general meeting. The use of: voting caps; shares with double or multiple voting rights; shares with limited or non-existent voting rights; participation rights carrying no votes; time-lapse voting schemes; discriminatory quorum requirements; irrevocable proxies; binding voting agreements or voting trusts; supermajorities; and "golden shares".

18.4 Price-increasing Defences

Firms have increasingly adopted takeover defences designed to make refinancing more expensive and generally to increase share price. As a rule, such takeover defences are legally unproblematic.

Pre-bid refinancing steps. The potential target company can simply take, in advance, the same refinancing steps that the acquirer would take following the successful completion of the acquisition. This involves making the firm leaner, focusing on core businesses, divesting other than core assets, increasing the firm's debt-to-equity ratio, and distributing distributable funds to shareholders by means of dividend payments, share buy-backs, or withdrawal of shares otherwise. If the company already is loaded with debt and has little distributable assets, it does not look like a promising LBO target.

Refinancing can be made more expensive by corporate decisions that can typically be taken at board level. Some transactions must be authorised by the general meeting (for important transactions, see Volume I; for distributions, see section 10.2.2; for frustration of the bid, see section 17.2).

However, the sale of assets that can be divested in the short term can increase the costs of the firm in the long term and prove fatal in the worst case (see the Stora Enso case, Volume I).

Higher share price, restructuring. Whereas a low share price can attract bidders, a high share price can keep them away – provided that the company already is lean. If the company has a conglomerate structure, its share price might not reflect fully the value of its various businesses. This can provide an opportunity for an acquirer to make a profit after the acquisition by breaking the target up and selling the pieces for more than it paid for the entire company. In order to avoid the conglomerate discount, a company can make its business more transparent by focusing on its core business and divesting the rest (for exit, see section 10.5).

When Mittal Steel made an offer for Arcelor, Arcelor used a mix of takeover defences designed to increase share price and to make refinancing more expensive for Mittal Steel: Arcelor raised new debt; increased dividend payments; and decided to distribute further assets to shareholders (section 18.11). Other takeover defences included an asset lock-up (for Dofasco shares, see below) and turning to a white knight (Severstal).

When InBev, a large Belgium-based brewer, made an unsolicited bid for Anheuser-Busch, a large American brewer, Anheuser's board: rejected InBev's bid in July 2008 calling it "financially inadequate" and not in the best interests of its shareholders; introduced a cost reduction program that included the firing of 1300 employees; and raised its share buybacks.

Sell-out provisions in the articles of association. The sell-out rights of other shareholders can increase the amount of shares that the acquirer must buy and increase the price that the acquirer must pay.

Particular sell-out provisions in the articles of association can be useful even though the duty to make a mandatory bid, squeeze-out rights, and sell-out rights have partly been regulated by the Directive on takeover bids. This is because the provisions of the Directive are subject to many exemptions.

The Directive only applies where the target company's shares have been admitted to trading on a regulated market in the EU. The obligation to make a mandatory bid does not apply where control has been acquired following a voluntary bid.[14] Where the obligation to make a mandatory bid does apply the threshold can be too high,[15] the price will be no more than the statutory equitable price,[16] and the consideration can consist of "liquid securities" rather than cash.[17] The sell-out right under the Directive on takeover bids only applies where a very high threshold has been exceeded "following a bid made to all the holders of the offeree company's securities for all of their securities",[18] and when it does apply, minority shareholders as a rule cannot ask for a higher price than the price that the bidder has paid previously.[19] For example, the articles of association of Nokia Corporation, a Finnish company, therefore provide for a more general sell-out right in the event of a takeover.[20]

On the other hand, where the target's board refuses to negotiate with potential bidders and relies on a low threshold, which triggers a duty to make a mandatory bid, or on shareholders' sell-out rights, there is risk that those potential bidders will choose to make a hostile bid in the absence of other alternatives.[21]

18.5 Keeping Assets Away from the Acquirer

The Report of the High Level Group of Company Law Experts[22] identifies many ways to keep assets away from the acquirer. They include, first, "barriers to exertion of control over the assets of the target" such as: the sale of assets ("scorched earth"); spin-offs; lock-ups of corporate assets ("crown jewels"); and change of control clauses in non-financial agreements. Second, they can also consist of the "creation of financial burdens as a consequence of the transfer of control" in the form of: poison debt; golden and tin parachutes; as well as change of control clauses in loan agreements.

Change of control clauses. Although change of control clauses can de facto function as a takeover defence, they are typically required by asset investors (sections 3.3.1 and 9.2) and substantial financial investors who want to mitigate the risk of a material adverse change in circumstances surrounding their investment (section 4.3) and counterparty commercial risk in general (Volume II).

Lock-ups of corporate assets. Corporate assets can be locked up, for example, through sale and lease-back transactions or by transferring assets to friendly enti-

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14 Article 5(2) of Directive 2004/25/EC (Directive on takeover bids).

15 Article 5(3) of Directive 2004/25/EC (Directive on takeover bids).

16 Article 5(4) of Directive 2004/25/EC (Directive on takeover bids).

17 Article 5(5) of Directive 2004/25/EC (Directive on takeover bids).

18 Article 16(1) of Directive 2004/25/EC (Directive on takeover bids).

19 Articles 16(3) and 15(5) of Directive 2004/25/EC (Directive on takeover bids).

20 Article 13 of the Articles of Association of Nokia Corporation.

21 Fleischer H, Finanzinvestoren im ordnungspolitischen Gesamtgefüge von Aktien-, Bankaufsichts- und Kapitalmarktrecht, ZGR 2008 p 201.

22 Commission of the European Communities, Report of the High Level Group of Company Law Experts on Issues related to Takeover Bids, 10 January 2002.

ties that will remain independent of the target company after the completion of the acquisition.

This can be illustrated by the Arcelor/Mittal case and the TUI case. One of the takeover defences used by Arcelor against Mittal Steel (section 18.11) was the transfer of Dofasco shares to an independent Dutch foundation named "Strategic Steel Stichting" (S3). Arcelor retained full control over Dofasco, including all decision-making power and all economic interest relating to Dofasco, with the exception of any decision to sell Dofasco. S3 board members had independent control over any decision to sell Dofasco. This takeover defences caused Arcelor and Mittal Steel problems after the merger, because S3's board of directors could block the sale of Dofasco shares to any party.

TUI AG is a company listed in Frankfurt. In 2008, TUI AG had two major divisions. It was the largest European travel company and number 5 in container shipping worldwide. Its shipping activities were organised under Hapag-Lloyd AG, one of the most important companies in Hamburg. Mr John Fredriksen, a Norwegian shipping magnate and the largest shareholder of TUI AG, tried to force TUI AG to spin off Hapag-Lloyd to TUI AG's shareholders. Mr Fredriksen also tried to raise his stake and threatened TUI AG with an injunction preventing the sale of Hapag-Lloyd. In October 2008, however, the supervisory board of TUI AG approved the sale of all shares in Hapag-Lloyd AG to a subsidiary of Albert Ballin KG, a holding company formed by investors based in Hamburg, the acquisition of a 33.33% entrepreneurial stake in the acquisition vehicle, and the payment of a special dividend to the shareholders of TUI AG following the completion of the sale. TUI AG could sell shares in Hapag-Lloyd AG without seeking shareholder approval.

18.6 Securities Lending

A particular form of keeping assets away from the reach of the acquirer is the use of securities lending to keep shares in friendly hands. Such methods include the soft parking strategy and lending to friendly investors.

Soft parking. The soft parking strategy is based on the use of the target company's own shares.[23] The target company can lend its own shares to a friendly investor and hedge its risk by a swap agreement.

The soft parking strategy was used by MOL Group, a Hungarian conglomerate and one of the largest firms in Central Europe, when it defended itself against a hostile takeover by OMV, an Austrian oil and gas company.[24] MOL could keep on buying its own shares regardless of the 10% cap,[25] because it lent most of its purchases to two Hungarian banks. As the borrower of shares becomes a shareholder with full voting rights, the banks were free to vote with their shares as they pleased. However, they had agreed not to sell them to a third party.

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[23] For the definition of soft parking, see Hu HTC, Black BS, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, U Penn L R 156 (2008) pp 625–739 at p 638.

[24] The Hungarian defence, The Economist, August 2007.

[25] Article 19(1)(b) of Directive 77/91/EEC (Second Company Law Directive).

Lending subsidiary shares to friendly investors. The target company can park even subsidiary shares. Lending shares to friendly investors under very long securities lending contracts can keep them away from the reach of the hostile bidder.

This strategy was used in Japan in 2005 when Livedoor made a hostile bid for Nippon Broadcasting System and announced that it had acquired 35% of its shares. Livedoor was interested in Nippon Broadcasting Systems because Nippon owned 22.5% of shares in Fuji Television Network. Nippon Broadcasting System kept the economic ownership but lent voting rights in Fuji Television Network to Softbank Investment and Daiwa Securities under two securities lending contracts. The parties could not rescind the contracts without mutual consent.[26]

18.7 The White Knight Defence

The board of the target may use the white knight defence subject to the legal rules that govern its actions generally. There are no particular constraints under Community law.[27] However, the general constraints apply (section 18.1).

In the US, white knights proposing a leveraged buyout of the target in response to a hostile takeover bid frequently require an engagement fee, requiring the target to pay a relatively small fee as consideration for the white knight's preparation and submission of its bid.[28]

Whether such payments are possible even in the EU dependes on the interpretation of EU company law. (a) In principle, the payment of such a fee could also be constrained by the purpose of the target company and its articles of association. However, where it is in the interests of the firm to find a white knight, it can be in the interests of the firm to bear some of the white knight's costs to the extent that it is permitted by other company law rules. (b) Restrictions on financial assistance can apply.[29] It is open to what extent the stated purpose of the payments is relevant (section 20.4). If the stated purpose of the payments is relevant, it still remains open whether reimbursement for costs other than the price of shares, or payments made for services rendered to the target company in the context of the acquisition, fall within the scope of the prohibition. (c) Cancellation fees, i.e. provisions for monetary compensation of the favoured bidder in the event the transaction fails to go forward, are common in negotiated acquisitions. The use of cancellation fees or liquidated damages is usually permitted subject to some restrictions (section

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[26] For the reasons for this clause, see Hu HTC, Black BS, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, Southern Cal L R 79 (2006) pp 811–908 at pp 841–842.

[27] Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).

[28] Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 180–181.

[29] The target company "may not advance funds … with a view to the acquisition of its shares by a third party". Article 23(1) of Directive 77/91/EEC (Second Company Law Directive).

12.4.3 and Volume II). Topping fees are a variation of cancellation fees in the US.[30]

18.8 Poison Pills, Shareholder Rights Plans

In the US, the poison pill is the target board's default takeover defence. The use of poison pills has significantly raised the bidder's costs in hostile tender offers and reduced the frequency of hostile bids. Virtually all bidders prefer to approach the target management with a proposal to negotiate.[31] However, there is a fundamental difference between US law and the laws of the Member States of the EU. US-type poison pills would not necessarily work in the EU. What are US-type poison pills, and why would they not work in the EU?

US-type poison pills. A modern US-type poison pill consists of a shareholder rights plan combined with three additional elements: a "flip-in" element; a "flip-over" element; and a redemption provision.[32] (a) When adopting the poison pill, the corporation issues to its stockholders rights to purchase stock. The rights are not exercisable until a triggering event. The triggering event is that someone acquires a certain percentage of the firm's voting shares. (b) If triggered, the rights give each holder, other than the stockholder that triggered the pill, the right to purchase shares of the issuing corporation (flip-in) or of the acquirer (flip-over) at a deep discount to then market price. The pill's flip-over feature is typically triggered if, following the acquisition, the target is subsequently merged into the acquirer or one of its affiliates.[33] (c) Pending their exercise, the rights may be redeemed for a nominal value by the board. The exercise price exceeds the original market price (meaning that the rights are originally out of the money).[34]

In *Moran v Household International*,[35] the Delaware Supreme Court upheld Household International's flip-over pill as reasonable under the *Unocal* standard (for Unocal, see section 17.2 and Volume I).[36] Such poison pills have sometimes been used even in other countries. For example, in *Stena Finance v Sea Containers*,[37] the Supreme Court of Bermuda con-

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[30] Bainbridge SM, *op cit*, pp 180–181: "Instead of specifying the dollar amount to be paid if the merger is not consummated, a topping fee requires that the target pay the defeated offeror a percentage of the victorious bidder's acquisition price. In either case, the fee ordinarily falls in a range of 1 to 5% of the proposed acquisition price. Payment of the fee is commonly triggered by the acquisition of a specified amount of target stock by a third party."

[31] Betton S, Eckbo BE, Thorburn KS, Corporate Takeovers. In: Eckbo BE (ed), Handbook of Corporate Finance: Empirical Corporate Finance, Volume 2. North-Hollande/Elsevier, Handbooks in Finance Series (2008), Chapter 15.

[32] See Bainbridge SM, *op cit*, p 316.

[33] See *ibid*, p 317.

[34] See Betton S, Eckbo BE, Thorburn KS, *op cit*.

[35] Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985).

[36] Unocal Corp. v. Mesa petroleum Co., 493 A.2d 946, 955 (Del. 1985).

[37] Stena Finance BV v Sea Containers Ltd (1989) 39 WR 83 (Supreme Court of Bermuda).

firmed that the adoption of such a rights plan by the board of a Bermuda company could constitute a "proper and constitutional" exercise of the board's powers.[38]

Community law. US-type poison pills are rare in the EU. Basically, EU company law does not prohibit shareholder rights plans. However, the other components of poison pills typically are not compatible with the provisions of EU company law or Member States' national company laws.

All transactions by the company are constrained by the purpose of the company under Member States' national company laws and company law rules according to which the powers must be exercised for a proper purpose.

According to the Second Company Law Directive, any increase in capital must be decided on by the general meeting.[39] The board may be authorised to decide on a limited increase in capital for a limited period of time (section 5.4).[40] Shareholders – even the bidder – have pre-emptive rights (section 5.4).[41] After becoming a shareholder, the bidder is protected by the principle of equivalent treatment of shareholders in the same position (Volume I).[42] The bidder is also protected by restrictions on targeted repurchase actions (see below).

18.9 Greenmail and Other Targeted Repurchase Actions

For legal reasons, greenmail and other targeted repurchase actions are rare in the EU. They are governed by the same rules.

Greenmail. Greenmail means repurchasing shares from a hostile acquirer by paying a substantial premium over the market price. However, share buy-backs are generally constrained by the principle of equivalent treatment of all holders of shares who are in the same position[43] as well as by: restrictions on the distribution of assets to shareholders and the amount of distributable assets;[44] provisions on corporate decision-making;[45] and an optional 10% cap.[46]

Other targeted repurchase actions. Other targeted repurchase actions are constrained by the same rules. The rules are more flexible in Delaware. For example, the right to undertake a targeted repurchase was upheld by Delaware Supreme Court in the famous *Unocal* case.[47]

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[38] See Walcott LA, Poison Pills in the Commonwealth Caribbean, JBL 1996 pp 206–219.

[39] Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).

[40] Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).

[41] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).

[42] Article 42 of Directive 77/91/EEC (Second Company Law Directive). See also recitals 2 and 5. Article 3(1)(a) of Directive 2004/25/EC (Directive on takeover bids).

[43] Article 42 of Directive 77/91/EEC (Second Company Law Directive) and Article 13(1) of Directive 2004/109/EC (Transparency Directive).

[44] Article 15 of Directive 77/91/EEC (Second Company Law Directive).

[45] Article 19(1)(a) of Directive 77/91/EEC (Second Company Law Directive).

[46] Article 19(1) of Directive 77/91/EEC (Second Company Law Directive).

[47] See Betton S, Eckbo BE, Thorburn KS, *op cit*.

18.10 Tactical Litigation, Administrative Constraints

The existence of legal rules on takeovers and acquisitions means that tactical litigation and appealing to competent authorities may be available as a takeover defence. For example, the target's board may appeal to the courts for an injunction to restrain the offeror from proceeding with the offer, on the grounds that there has been a breach of securities regulations, a breach of competition laws, or other improper conduct.

Examples. Until the poison pill became the standard frustrating measure, tactical litigation was virtually automatic in the US, and it still is a common takeover defence. For example, the takeover contest between E.ON AG (the German energy giant) and Acciona SA (a Spanish company in the renewable energies business) for control of Endesa SA (Spain's largest electrical utility) was fought in the courtrooms of the Southern District of New York.[48]

There are many examples of the use of tactical litigation even in Europe. In the London market, the City Code makes appealing to national or Community competition authorities (the Competition Commission or the European Commission) a takeover defence in hostile takeover bids. It must be a term of the offer that it will lapse if there is a reference to competition authorities in some circumstances.[49] It is easier to use tactical takeover litigation as a defence after the implementation of the Directive on takeover bids in the UK. In the past, the City Code lacked statutory force; the Takeover Panel now has statutory powers in relation to bids to which the Directive relates.[50]

The nature of tactical litigation. Takeover litigation may be pre-contest, contemporaneous with the contest, or post-contest.[51] It adds to the transaction costs of takeovers. The costs are not limited to direct litigation costs and costs for compliance. It is even more important that the offeror must raise funding for the offer, and its funding costs depend on the length of time those funds must be employed. The threat of tactical litigation increases legal risks.

Community law. The effect of Community law on tactical litigation is basically indirect. As Community law requires statutory provisions on takeovers policed by Member States' competent supervisory authorities, it is easier for a party to appeal to those authorities or the court.

In regulated industries such as banking and insurance, the existence of common requirements can mean that the competent supervisory authorities are receptive to arguments made by the target itself maintaining that the takeover would not be consistent with those requirements and public policy.

As regards concentrations that have a Community dimension, the one-stop shop principle (section 14.2) makes it more difficult to use cumulative competition law

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[48] Ogowewo TI, Tactical Litigation in Takeover Contests, JBL 2007 pp 589–590.

[49] Rule 12 of the City Code on Takeovers and Mergers.

[50] Sections 942 and 943 of the Companies Act 2006.

[51] Generally, see Ogowewo TI, Tactical Litigation in Takeover Contests, JBL 2007 pp 589–619.

proceedings as a defence. The same can be said of the principle of home-country control in regulated industries.

Furthermore, the EU legal capital regime regulates the disclosure of information to shareholders and makes many transactions subject to shareholder consent. It can therefore be easier for shareholders to block transactions depending on the law governing the company. For example, the wide powers of shareholders under German company law have recently been constrained in order to prevent abusive litigation.

18.11 Example: Arcelor and Mittal

The Directive on takeover bids has an effect on takeover defences. Its effect can be illustrated by the case of Arcelor and Mittal Steel. The takeover defences applied by the board of Arcelor were not fully compatible with the provisions of the Directive on takeover bids.

Parties. The main parties of the case were Arcelor, Mittal Steel, Dofasco, and Severstal. One can say that Arcelor and Mittal Steel competed for the position as the largest steel producer and the domination of world steel markets. (a) In 2006, Arcelor was a "Société Anonyme" (SA, limited-liability corporation) incorporated under Luxembourg law. Arcelor shares were listed on the Luxembourg stock exchange as well as on the Euronext Brussels, Euronext Paris, and in the four Spanish stock exchanges. Arcelor was created by the merger of Aceralia, Arbed, and Usinor. According to Arcelor, Arcelor was the number one steel company in the world. (b) Mittal Steel was a "naamloze vennootschap" (N.V., limited-liability corporation) incorporated under Dutch law. Mittal Steel's shares were listed on the New York and Amsterdam stock exchanges. In early 2006, Mittal Steel was controlled by Lakshmi Mittal, an Indian-born but London-based tycoon and one of the richest people in the world. According to Mittal Steel, Mittal Steel was the world's largest and most global steel company. (c) Dofasco was a large North American steel company. (d) Severstal was a Russian company controlled by Alexey Mordashov, a billionaire with close relations with Vladimir Putin who was the Russian president at the time. Severstal was the largest Russian steel producer. In addition, Severstal owned Severstal North America, the fifth largest integrated steel maker in the US, and Lucchini, Italy's second largest steel group.

Arcelor/Dofasco. On 30 December 2005, Arcelor made a bid for Dofasco. After increasing its bid on 16 January 2006, Dofasco and Arcelor reached agreement on 24 January 2006. Dofasco's Board of Directors decided to recommend to Dofasco shareholders that they accept Arcelor's offer. During March and April 2006, Arcelor acquired 100% of the shares of Dofasco.

Mittal/Arcelor. On 27 January 2006, Mittal Steel made an unsolicited offer of €18.6 billion in cash and shares for Arcelor. Under the terms of the deal the family of Lakshmi Mittal would keep a controlling stake in the merged company. The original bid was valid till 28 April 2006. A Letter Agreement dated 26 January 2006 between Mittal Steel and ThyssenKrupp, a German company, provided that,

if Mittal Steel were successful in its tender offer for Arcelor and able to exert management control "with the ability to sell Dofasco", Mittal Steel would cause Arcelor to sell Dofasco to ThyssenKrupp.

Board reaction. On 29 January 2006, that is, two days later, Arcelor's board rejected the offer. Arcelor's chief executive described in public the bid as "150%" hostile. He also drew a contrast between Mittal and Arcelor's "European cultural values" (even though the bidder was a Dutch company based and listed in the Netherlands and controlled by a London-based tycoon). He claimed that Arcelor was producing "aristocratic perfume" whilst Mittal was making "plebeian eau de cologne", and refused to accept that there could be any industrial logic to the takeover plan. He even said that he did not want his shareholders to be paid with the Indian-born Lakshmi Mittal's "monkey money".[52]

According to the Directive on takeover bids, however, Arcelor's board should have acted in the interests of the company as a whole.[53] Arcelor's shareholders should have been given sufficient information to enable them to reach a properly informed decision on the bid,[54] and the board should have drawn up and made public a reasoned opinion of the bid.[55]

Divestment of Ugitech. On 10 March 2006, Arcelor entered into an exclusivity agreement for the sale of 100% of its stainless long products subsidiary Ugitech, a French company, to Schmolz Bickenbach AG. Ugitech sold 200,000 tons of products every year. Arcelor produced tens of millions of tons.

In principle, the sale of a subsidiary could have been part of a crown jewels defence that would have required shareholder consent. However, in this case the sale was not prohibited by provisions implementing the Directive on takeover bids as it was not likely to frustrate the bid.[56] Ugitech was a tiny company compared with Arcelor as a whole.

Financing of defensive measures. In March and April 2006, Arcelor took defensive measures. Arcelor started by raising funding. On 30 March 2006, Arcelor signed a €4 billion Term Loan Facility with a 3 year maturity. Arcelor did not make this loan facility publicly known at the time.

It is important to note that the main rule under the Market Abuse Directive is that issuers must publish information which would be likely to have a significant effect on share price[57] but do not have to make public information which is not likely to have such an effect. Taken out of context, the term loan facility might not have triggered a disclosure obligation under the Directive on market abuse. However, if the term loan facility had formed part of the defensive measures employed by Arcelor, it should have been disclosed.

The purpose of the term loan facility soon became clear as Arcelor's board disclosed some defensive measures on 3 April 2006. On 26 April 2006, Arcelor fi-

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52 Arcelor, up in arms, The Economist, April 2006.
53 Article 3(1)(c) of Directive 2004/25/EC (Directive on takeover bids).
54 Article 3(1)(b) of Directive 2004/25/EC (Directive on takeover bids).
55 Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).
56 Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).
57 Article 6(1) of Directive 2003/6/EC (Directive on market abuse).

nally disclosed the €4 billion Term Loan Facility and said that the facility would be used by Arcelor "to maintain its financial flexibility after recent acquisitions". Although Arcelor did not mention it, it was clear that Arcelor had to fund the following takeover defences.

General remarks about Arcelor's defensive measures. On 3 April 2006, Arcelor's board decided to take measures allegedly "in the interest of its shareholders". The board disclosed three things. Their hidden purpose was to increase share price (and make the takeover more expensive ex ante), reduce distributable assets and increase debt (and make refinancing more difficult after the completion of the takeover), and transfer important assets away from Mittal's reach (the crown jewels defence). Those defences were followed by a white knight defence.

Dividends. The first defensive measure was a proposal to increase dividends from €1.20 to €1.85 per share. According to an earlier proposal submitted by the board, the general meeting of shareholders to be held on 27 April 2007 had been asked to approve the distribution of a gross dividend of only €1.00 per share with respect to 2006, compared with €1.20 per share for 2005. The new proposal did not infringe the provisions of the Directive on takeover bids, as the payment of dividends to shareholders had to be decided on by shareholders under the governing law anyway.[58]

Other distributions. The second measure was to distribute a further €5 billion to shareholders as would later be decided by the board. The board indicated that such payment "could take the form of a share buyback, an extraordinary dividend payment or a self tender offer in between the date of the annual general meeting … and the end of the 12th month following the withdrawal or failure of Mittal Steel's hostile offer on Arcelor". On 12 May 2006, Arcelor called an extraordinary general meeting of shareholders for 19 May 2006. The agenda contained a draft resolution providing for a public offer to buy back shares of the company for the purpose of their cancellation.

Transfer of Dofasco. The third proposal was controversial. According to Arcelor's board, shares in Dofasco would be transferred to an independent Dutch foundation named "Strategic Steel Stichting" (S3). Arcelor would retain full control over Dofasco, including all decision-making power and all economic interest relating to Dofasco, with the exception of any decision to sell Dofasco. The S3 Board members would have independent control over any decision to sell Dofasco. According to the Directive on takeover bids, decisions which may result in the frustration of the bid would nevertheless need to be ratified by the general meeting.[59] On 3 April 2006, Arcelor transferred 89% of the shares of Dofasco to the Stichting, thereby removing Arcelor's ability to sell or otherwise dispose of such shares without the Stichting's consent. This decision came to haunt both Arcelor and Mittal later (see below).

White knight. On 26 May 2006, Arcelor and Severstal announced that they had agreed to merge. (a) In the proposed deal Arcelor would buy the 90% stake of Severstal belonging to Alexei Mordashov, as well as all of his other steel and min-

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[58] See also Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).
[59] Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).

ing assets. Alexei Mordashov, in return, would receive Arcelor shares and buy more with cash. This would give him a 32% stake in the new Arcelor. (b) Severstal (Alexei Mordashov) was entitled to a €140 million "break-up fee" in the event that the deal failed. (c) Arcelor's managers claimed that, according to Arcelor's by-laws, they did not have to ask for shareholders' opinion on the Severstal deal at all. Shareholders were nevertheless told that they would be given a chance to veto the Severstal transaction. According to the proposal, a simple majority of votes cast would not be sufficient to veto the transaction; at least 50% of the shareholder base would have to vote against it. Losing the vote was unlikely, because on average only about a third of shareholders turned up at meetings of Arcelor's shareholders. (d) The board of Arcelor tried to benefit from several loopholes in Community law. The Directive on takeover bids provides that the board may not, without the consent of shareholders, take any action which may result in the frustration of the bid, but the Directive permits the board to seek alternative bids and look for a "white knight" without the consent of shareholders.[60] The Second Directive provides for the pre-emptive rights of shareholders, but this requirement does not apply where, as is the case here, capital is increased by consideration other than in cash.[61] The Second Directive does require that any increase in capital must be decided upon by the general meeting,[62] but the Directive does not require any particular majority.[63]

On 11 June 2006, Arcelor's board formally decided to reject Mittal Steel's revised offer and to recommend that shareholders support the proposed merger with Severstal. By this time, shareholders and the media nevertheless had become increasingly critical about the governance of Arcelor.[64]

Acceptance of offer. On 25 June 2006, Arcelor's board finally decided to recommend Mittal Steel's improved offer to shareholders. The board of Mittal Steel recommended the transaction to Mittal Steel's own shareholders. The combined group would be domiciled and headquartered in Luxembourg and named Arcelor Mittal. The Mittal family would own 43% of the combined group.

In September 2006, 93.7% of Arcelor shareholders tendered their shares to Mittal Steel. The laws of Luxembourg provided for a sell-out right.[65] Arcelor and Mittal encouraged shareholders to exercise that right. They also announced that Mittal would use its squeeze-out right under the Directive on takeover bids.[66]

A two-step merger process between Mittal Steel and Arcelor followed in 2007. In the first step, Mittal Steel merged into its subsidiary ArcelorMittal S.A, a company founded under the laws of Luxembourg. Mittal Steel shareholders voted on

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[60] Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).

[61] Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).

[62] Article 25(1) of Directive 77/91/EEC (Second Company Law Directive).

[63] See Article 40 of Directive 77/91/EEC (Second Company Law Directive).

[64] Arcelor, up in arms, The Economist, April 2006; Treating shareholders as pig iron, The Economist, June 2006; Cast-iron, The Economist, June 2006.

[65] Article 16 of Directive 2004/25/EC (Directive on takeover bids).

[66] Article 15 of Directive 2004/25/EC (Directive on takeover bids).

the merger at an extraordinary general meeting of shareholders held on 28 August 2007.[67] In the second step, ArcelorMittal and Arcelor S.A. merged.

Epilogue: Dofasco. In order to resolve certain US competition law concerns, the US Department of Justice filed with the US District Court in Washington, D.C. on 1 August 2006 a Consent Decree in which Mittal Steel agreed to use its best efforts to sell Dofasco to ThyssenKrupp or, if Dofasco could not be sold due to the Stichting, to sell certain alternative assets. The boards of Mittal Steel and Arcelor formally requested that the Stichting dissolve and return the Dofasco shares to Arcelor. On 10 November 2006, the Stichting's board refused. The prospects of achieving the dissolution of the Stichting and the return of the Dofasco shares against the wishes of the Stichting's board were remote. One can say that this takeover defence backfired.

[67] Article 7 of Directive 78/855/EEC (Third Company Law Directive).

19 A Listed Company as the Target

19.1 General Remarks

The takeover of a company whose shares have been admitted to trading on a regulated market is subject to a larger and more detailed regulatory regime under Community law. This chapter will provide a summary of the most important rules. These questions have partly been discussed in other parts of this book. Many of them can better be discussed in specialist works.

Nature of the acquisition. The acquisition of a listed company is fundamentally different from the acquisition of a privately-owned company. (a) Where the target is a listed company, the acquirer can negotiate only with the target's management, controlling shareholders, or other substantial shareholders. (b) The acquisition can be a going-private transaction (LBO, MBO, private-equity deal). Alternatively, the target company can remain listed, provided that it still fulfils the admission requirements (for delisting, see section 5.9.9). (c) The acquisition of a listed company can be structured as a merger, or as a public takeover bid (tender offer) followed by the squeeze-out of minority shareholders. (d) Regardless of its form, the acquisition is always governed by an extensive disclosure and information management regime.

Mergers v public takeover bids. There are differences between mergers and public takeover bids.

Mergers are always friendly. A merger requires an agreement between the participating companies' boards (section 5.11.3) and shareholder approval. However, a resolution authorising a merger only requires a majority or a qualified majority. If such a resolution is legally passed, dissenting shareholders cannot prevent the merger; dissenting shareholders typically have appraisal rights. The merger process tends to be lengthy because of mandatory provisions of law protecting shareholders in general, dissenting shareholders, and third parties.

In contrast to the merger process, a public takeover bid neither requires prior approval by nor prior contact with the target or its management. A public takeover bid can be friendly or hostile. Many public takeover bids do involve prior contact and even negotiations with the target management. "Negotiated tender offers" may help to resolve bargaining issues such as differences of opinion on what constitutes a reasonable bid price.[1]

A public takeover bid can be limited to a certain amount of shares and be conditional. Unlike a merger process, a public takeover bid is relatively quick. The

[1] See Betton S, Eckbo BE, Thorburn KS, *op cit*.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
DOI 10.1007/ 978-3-642-03058-1_19, © Springer-Verlag Berlin Heidelberg 2010

speed of the process depends on the governing law and the applicable stock exchange rules. In London, the City Code requires a very tight schedule.

In market practice, the offer is more likely to be a public takeover bid when: the target is defensive; the target has high institutional ownership; there are multiple bidders; or the offer is an all-cash offer.[2]

Absence of remedies for the acquirer. In both mergers and public takeover bids, the large number of vendors (the target's shareholders) means, in practice, that the acquirer cannot have any post-closing remedies in the event that the target does not live up to expectations. There is neither price adjustment nor indemnity.[3]

Information management. For many reasons, information management plays a major role before the acquisition of a listed company. One of them is the absence of post-closing remedies. The most important reason is compliance. There is large, detailed, and mandatory information regime consisting of: the mandatory disclosure regime for companies whose shares have been admitted to trading on a regulated market; the prohibition of insider trading and market manipulation; and the disclosure regime applied in the context of public takeover offers.

A very large part of insider deals occur immediately before or during a bid. This is because: a merger or takeover offer is usually launched at a premium; the prospect of an offer can cause a major and sudden change in share price in all participating companies; the preparation of the offer involves discussions inside the offeror company and with various advisers; and it can involve discussions even with the target company and many outsiders.[4]

Regulation. Because of the nature of acquisitions, there cannot be a regulatory regime covering all aspects of listed company mergers and acquisitions in the Member States. However, a wide range of rules applies depending on the circumstances and types of companies involved.

The Transparency Directive requires the disclosure of major holdings. Disclosure of major holdings is also required in regulated industries like banking, insurance, and investment services in general. Public takeover bids are governed by the Directive on takeover bids and implementing legislation. The Directive on market abuse and implementing legislation play an important role. In addition, the parties must comply with securities markets laws generally. The disclosure and confidentiality regime is complemented by the principle of equivalent treatment.[5]

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[2] Kohers N, Kohers G, Kohers T, Glamour, value, and the form of takeover, J Econ Bus 59(1) (2007) pp 74–87. See also *ibid*.

[3] Goldberg L, Acquisition Agreements from a Business Perspective (Principal Focus: Private Company Acquisition for Cash). In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice, Corporate Law and Practice Course Handbook Series. New York City (2008) pp 222–223.

[4] Davies PL, The Take-over Bidder Exemption and the Policy of Disclosure. In: Hopt KJ, Wymeersch E, European Insider Dealing - Law and Practice. Butterworths, London (1991) p 243, citing Hannigan B, Insider Dealing. London (1988) p 19.

[5] Articles 19(1) and 42 of Directive 77/91/EEC (Second Company Law Directive); Article 17(1) of Directive 2004/109/EC (Transparency Directive); Article 3(1) of Directive 2004/25/EC (Directive on takeover bids).

Governing law. The governing law depends on the classification of the issue. (a) Each participating company will be governed by the company law of the country of incorporation (*Inspire Art*, see Volume I). (b) The public law governing trading is that of the home Member State of the regulated market.[6] The authority competent to supervise a public takeover bid is usually that of the Member State in which the offeree company's securities are admitted to trading on a regulated market.[7] (c) Another main rule is the principle of home country control of issuers.[8] (d) However, each Member State must apply the insider trading and market abuse regime to actions carried out on its territory or, where the actions concern financial instruments that are admitted to trading on a regulated market situated or operating within its territory, abroad.[9]

In *England*, limited-liability companies are governed by the Companies Act 2006. The City Code on Takeovers and Mergers sets out the rules which regulate bids for companies incorporated in the UK where their shares have been admitted to trading on a regulated market in the UK. It applies even to some other companies.[10] Since the implementation of the Directive on public takeover bids in May 2006, the City Code has statutory effect. The City Code is enforced by the Panel on Takeovers and Mergers, subject to judicial review. The Panel on Takeovers and Mergers is an independent body that has been designated as the supervisory authority. Its statutory functions are set out in the Companies Act 2006.[11] Companies with securities listed on the Official List of the London Stock Exchange must also comply with the Listing Rules of the UK Listing Authority (the FSA acts as the UKLA). The UK also has a comprehensive financial services framework, including the Financial Services and Markets Act 2000 and the Criminal Justice Act 1993, which regulates investment activities and prohibits insider dealing and market manipulation.

In *Germany*, public limited-liability companies are governed by the Aktiengesetz (AktG). Public offers, public takeover bids and mandatory offers are governed by the Wertpapierübernahmegesetz (Securities Acquisition and Takeover Act, WpÜG). The WpÜG is enforced by the BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht).[12]

19.2 Information Management: Secrecy v Disclosure

In practice, the potential acquirer must maintain secrecy. If information about its plans leaks out too early, the takeover may become more expensive as the price of the target's shares will then reflect the price that the market expects the offeror to pay. On the other hand, a potential acquirer must plan the takeover internally and take care of its internal decision-making. It will need advice, and it will have to contact outsiders in order to arrange financing, organise a consortium, or negotiate

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[6] Articles 36(4) and 4(1)(20)(b) of Directive 2004/39/EC (MiFID).

[7] Article 4(2) of Directive 2004/25/EC (Directive on takeover bids). For problems, see Siems MM, SEVIC: Beyond Cross-Border Mergers, EBOLR 2007 p 316.

[8] For prospectuses, see Article 13(1) of Directive 2003/71/EC (Prospectus Directive).

[9] Article 10 of Directive 2003/6/EC (Directive on market abuse).

[10] Introduction, section 3 of the City Code on Takeovers and Mergers.

[11] Chapter 1 of Part 28 of the Companies Act 2006.

[12] See § 4 WpÜG.

the sale of assets that it will not want to keep after the acquisition. Even the target company may have to contact many advisers and other parties.

Securities markets laws can require secrecy by restricting selective disclosure of information and by prohibiting market abuse. On the other hand, securities markets laws typically require the disclosure of things that can influence the price of securities, unless there is a legitimate reason to delay disclosure (such as negotiations[13] or the need to obtain the supervisory board's consent in companies that have a two-tier board strutrure[14]). Securities markets laws also require disclosure when that legitimate reason to delay disclosure does not exist or has ceased to exist, and when the holdings of a shareholder have reached a certain threshold of votes. Even the target company may, at some point in time, have a duty to disclose negotiations or the existence of an offer.

Complicated legal framework. There is therefore tension between those two objectives (secrecy v disclosure). The same tension can be found in the regulation of secrecy and disclosure.

There are even other factors which add to the complexity of the matter and make it difficult to identify and interpret the applicable rules.

The information rules adopted at Community level to govern these issues are typically minimum rules. Different rules can be applied depending on the Member State.

This can be illustrated by the regulation of inside information in Germany and England. In Germany, the Securities Trading Act (WpHG) requires issuers to disclose inside information without undue delay.[15] There are exemptions. The issuer is obliged to notify the BaFin about the applicable grounds for exemption.[16] Mimimum confidentiality obligations based on the Directive on market abuse[17] are complemented by a broader requirement of secrecy which follows from the general provisions of company law (duty of care, secrecy)[18] and the general provisions of the law of obligations for members of the two boards and the advisers to whom they pass on information.[19]

In England, the duty to disclose inside information is based on the Listing Rules.[20] Inside information must be disclosed as soon as possible. If an issuer is faced with an unexpected and significant event, a short delay may be acceptable if it is necessary to clarify the situation.[21] There are exemptions.[22] Apart from the situations mentioned in DTR 2.5.3 R, there are unlikely to be other circumstances where delay would be justified.[23]

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[13] Article 3(1)(a) of Directive 2003/124/EC.

[14] Article 3(1)(b) of Directive 2003/124/EC.

[15] § 15 WpHG.

[16] § 15(3) WpHG.

[17] § 14 WpHG.

[18] § 93(1) and § 116 AktG.

[19] See Hopt KJ,Takeovers, Secrecy, and Conflicts of Interest: Problems for Boards and Banks (October 2002). ECGI - Law Working Paper No. 03/2002.

[20] LR 9.2.5 and DTR 2.2.1.

[21] DTR 2.2.9.

[22] DTR 2.5.1.

[23] DTR 2.5.5 G.

There can be personal confidentiality obligations on a number of grounds. A person can owe fiduciary duties based on the general law.[24] The City Code, which regulates takeover bids and certain other transactions, requires secrecy before the announcement of the bid,[25] and even rumours may trigger a duty to make an announcement under the City Code.[26]

The general law relies on civil remedies. There are regulatory sanctions and penalties for market abuse under the Financial Services and Markets Act 2000 (FSMA). The Criminal Justice Act 1993 makes insider dealing a criminal offence.[27]

The information rights and duties depend on the parties. There are generic information rights and duties applicable to a party in relation to a certain other party (see Volume I).[28] In the context of a takeover, the core parties are the acquirer, the vendor or vendors, and the target. The rules governing information management can be applied to each party separately, and there can be different rules depending not only on the identity of this party (for example, the duty of the target under rule X to disclose information) but also on the identity of the other party in the information relationship (for example, the duty of the target to keep information secret from the acquirer under rule Y).

In other words: Where a party is a company whose shares have been admitted to trading on a regulated market, it will be subject to the information management regime applicable to *issuers*. Where it is not such a company, it must nevertheless comply with rules that apply to *any market participant* (like the prohibition of market abuse) or to *any person* (like rules that make the gathering, use or disclosure of information a criminal offence). The identity of the party will influence *another party's* information rights and obligations.

Furthermore, those rules can be relevant in many situations in the context of takeovers. Usual situations in which the management of information is regulated by laws include the following:

[24] Percival v Wright [1902] 2 Ch 421; Schering Chemicals Ltd v Falkman Ltd [1982] QB 1.

[25] Rule 2.1 of the City Code on Takeovers and Mergers.

[26] Rule 2.2 of the City Code on Takeovers and Mergers.

[27] Section 52(1) of the Criminal Justice Act 1993.

[28] They include: the right to ask for information; the duty to ask for information; the right to disclose information; the duty to disclose information; the duty not to reveal information; the duty not to use information; the characteristics of information; the allocation of risk inherent in information; and similar questions.

Table 19.1 Regulation of the Management of Information in the Contect of Takeovers

	Potential acquirer (listed)	*Potential vendor (listed)*	*Target (listed)*
Stage of decisions on holdings	Actual size of holdings. Making plans to buy. Actual decision to buy. Changes in holdings.	Actual size of holdings. Making plans to sell. Actual decision to sell. Changes in holdings.	Actual size of shareholders' holdings. Knowledge of other parties' plans or actual decisions. Changes in holdings.
Stage of contracting	Negotations. Contracts.	Negotiations. Contracts.	Negotiations or contracts. Knowledge of other parties' negotiations or contracts.
Disclosure, use	Selective disclosure. Use of information disclosed selectively.	Selective disclosure. Use of information disclosed selectively.	Selective disclosure. Use of information disclosed selectively.
Public offer	Planning a public offer. Decision to make a public offer. Terms of the public offer. Various stages of the public offer.		Reaction to the public offer. The use of takeover defences. Various stages of the public offer.

As can be seen, there is no room to discuss all situations and all information relationships in this book. However, five common situations can be discussed from the perspective of a potential acquirer which is a listed company itself: (a) using a toehold strategy; (b) delaying the disclosure of its plans; (c) ensuring selective exchange of information; (d) acting in a certain capacity (acting in concert); and (e) making a public takeover bid.

19.3 Toehold, Creeping Takeover, Major Holdings

In principle, the prospective acquirer could benefit from acquiring a major holding of shares ("toehold") before making its intentions known. Information about a threatening takeover could cause the target to employ takeover defences. In addition, the valuation of the shares could change, as investors price the shares on the basis of how much the acquirer would be prepared to pay in the light of the private

benefits of control following a successful takeover.[29] Disclosure could also attract competing bidders, and speculators such as hedge funds might try to drive the share price up. For those reasons, early notification can cause the bid to fail.

The toehold strategy is customary in hostile takeover contests. First, the toehold reduces the number of shares that must be purchased at the full takeover premium. Second, the toehold may also be sold at an even greater premium should a rival bidder outbid the potential acquirer and win the takeover battle. Third, such toehold benefits can enable the bidder to raise its valuation of the target and pay a higher price for the remaining shares.[30]

In some cases, the benefits of a friendly bid (speed of execution, lack of takeover defences) can outweigh the potential benefits of the toehold strategy.

The toehold strategy is subject to legal constraints under Community law. The most important of them increase costs[31] by laying down an obligation to disclose major holdings (the Transparency Directive) and restricting exit (the Second Company Law Directive).

Although the acquirer of a major holding does not have a duty to disclose its plans under the Transparency Directive,[32] the disclosure of a toehold can de facto reveal its intentions. There are also other disclosure obligations.

Disclosure of plans to buy shares, pre-announcement trading. A party's decision to buy or sell shares can be inside information[33] as market information can influence share price.[34] Can that party buy or sell shares knowing that its own transactions are likely to have a significant effect on share price when made public?[35] Should it disclose its plans to buy or sell?

Although there is an obligation to disclose major holdings, there is no similar obligation to disclose plans to buy or sell. The mere fact that a party plans to buy or sell shares issued by another company does not trigger a disclosure obligation under the Directive on market abuse.

On the other hand, an issuer must disclose inside information "which directly concerns" the issuer itself.[36] If the prospective acquirer's shares have been admit-

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29 See Betton S, Eckbo BE, Thorburn KS, *op cit*.

30 See *ibid*.

31 A similar strategy was adopted in Germany in the government bill for the Risk Mitigation Act (RegE Risikobegrenzungsgesetz, BR-Drucksache 763/07). See also Fleischer H, Finanzinvestoren im ordnungspolitischen Gesamtgefüge von Aktien-, Bankaufsichts- und Kapitalmarktrecht, ZGR 2008 p 186.

32 This can be contrasted with US law. According to Section 13(d)(1) of the Securities Exchange Act of 1934, the statement must contain detailed information concerning the identity and background of the purchaser, its interest in the securities, the source and amount of funds or other consideration, the purpose of the transaction and any contracts, arrangements, understandings or relationships with respect to such securities.

33 Article 1(1) of Directive 2003/6/EC (Directive on market abuse).

34 See Davies PL, The Take-over Bidder Exemption and the Policy of Disclosure. In: Hopt KJ, Wymeersch E, European Insider Dealing - Law and Practice. Butterworths, London (1991) p 248.

35 See Recital 18 of Directive 2003/6/EC (Directive on market abuse).

36 Article 6(1) of Directive 2003/6/EC (Directive on market abuse).

ted to trading on a regulated market, it may thus have a duty to disclose something. If the prospective acquirer is a privately-owned company, it has no such disclosure obligations.

Furthermore, the target company may have a duty to disclose information about other parties' plans to buy or sell its shares provided that the disclosure of such information would be "likely to have a significant effect" on its own share price, the information is "of a precise nature", and the information is in its possession.[37]

The actual enforcement of one's own decision to buy or sell shares will not be regarded as the use of inside information about the existence of such a decision. The Directive contains an exemption: "Since the acquisition or disposal of financial instruments necessarily involves a prior decision to acquire or dispose taken by the person who undertakes one or other of these operations, the carrying out of this acquisition or disposal should not be deemed in itself to constitute the use of inside information."[38]

The City Code on Mergers and Takeovers provides for a "bidder exemption" after a policy change in 1972.[39] An offeror's own pre-announcement trading in the capacity of the offeror is thus not prohibited. In the US, a similar bidder exemption is based on section 14e of the Securities Exchange Act of 1934 and Rule 14e-3 adopted by the SEC under the Act.[40]

Disclosure of major holdings. Disclosure obligations can be triggered by trading. Like the 1968 Williams Act that amended the Securities Exchange Act of 1934,[41] the Transparency Directive lays down an obligation to disclose information about major holdings. The provisions of the Transparency Directive are complemented by special requirements to notify holdings in certain regulated businesses subject to prudential regulation and ownership controls.[42] This regime was amended in 2007.[43]

According to the Transparency Directive, a person acquiring or disposing of shares so that its holding with a publicly traded company reaches, exceeds or falls below certain thresholds must inform the company, which is in its turn responsible

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37 Article 1(1) of Directive 2003/6/EC (Directive on market abuse).

38 Recital 30 of Directive 2003/6/EC (Directive on market abuse).

39 Rule 4.1 of the City Code on Takeovers and Mergers.

40 See Davies PL, The Take-over Bidder Exemption and the Policy of Disclosure. In: Hopt KJ, Wymeersch E, European Insider Dealing - Law and Practice. Butterworths, London (1991) pp 244–248.

41 Section 13(d)(1) of the Securities Exchange Act of 1934 requires any person who acquires the beneficial ownership of more than 5% of any equity security of a class that is registered pursuant to Section 12 of the Exchange Act to make a filing on Schedule 13D. Under the 1976 Hart-Scott-Rodino Antitrust Improvements Act, share acquisitions exceeding a certain threshold trigger notification to the antitrust agencies.

42 See, for example, Article 10(3) of Directive 2004/39/EC (MiFID).

43 Directive 2007/44/EC amending Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector.

for disclosing this information to the public. The notification to the issuer must be effected as soon as possible, but not later than four trading days.[44]

The main rule is that the thresholds are 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75% of voting rights.[45] There are some exceptions.[46] Member States may also use a threshold of one-third instead of the 30% threshold, and a threshold of two-thirds instead of the 75% threshold.[47] What is more important is that the home Member State of an issuer may make the shareholder subject to requirements more stringent than those laid down in the Transparency Directive.[48] For example, the lowest threshold is 3% both under German[49] and English law, and the UK Listing Rules lay down a very strict disclosure regime for UK issuers.[50]

There are also rules designed to prevent circumvention of the disclosure obligation. For example, using a third party (acting in concert, see below) or obtaining rights other than title to the shares are covered by the Directive.[51] The use of shares as collateral or the use of an option right to acquire already issued shares can thus trigger a disclosure obligation. For example, a disclosure obligation can be triggered even where the size of the block owned by a party has been reduced by using a securities lending agreement.[52]

Constraints on exit. The toehold strategy means that the prospective acquirer ends up owning a substantial block of shares. However, the toehold strategy does not guarantee success. The prospective acquirer can lose the takeover contest, or the planned acquisition can fail for other reasons. Where no party succeeds in taking over the target, the pricing of target shares can change again and be determined not on the basis of the private benefits of a controlling shareholder (higher price) but on the basis of the distributions that the target company is expected to make to non-controlling shareholders in the long term (lower price).

If the prospective acquirer fails to obtain control, it may want to sell target shares at a profit. However, this can be constrained by laws.

First, those shares cannot, in practice, be sold to the target company. Share buy-backs are generally constrained by: restrictions on the distribution of assets to shareholders and the amount of distributable assets;[53] provisions on corporate de-

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[44] Article 12(2) of Directive 2004/109/EC (Transparency Directive).

[45] Article 9(1) of Directive 2004/109/EC (Transparency Directive). For the issuer's own shares, see Article 14(1).

[46] For exceptions, see Article 9(4) (clearing and settlement), Article 9(5) (market makers), Article 9(6) credit institutions and investment firms), Article 11 (members of the ESCB), and Article 12 (certain group situations).

[47] Article 9(3) of Directive 2004/109/EC (Transparency Directive).

[48] Article 3(1) of Directive 2004/109/EC (Transparency Directive). See also Article 3(2)(b).

[49] § 21(1) WpHG.

[50] DTR 5.1.2 R.

[51] Articles 10 and 13(1) of Directive 2004/109/EC (Transparency Directive).

[52] For Danish law, see § 4 of Bekendtgørelse om storaktionærer, nr 1225 of 22 October 2007.

[53] Article 15 of Directive 77/91/EEC (Second Company Law Directive).

cision-making;[54] and an optional 10% cap.[55] In practice, it is even more important that selective share buy-backs are constrained by the principle of equivalent treatment of shareholders. The existence of such restrictions also means that the target company cannot use greenmail as a defence (for greenmail, see section 18.9).

Second, the sale of a large block of shares on the market can depress share price. It can be difficult for the acquirer to increase the price by its own actions. There are also legal constraints. The prohibition of market manipulation[56] covers, for example, transactions which secure the price of financial instruments at an abnormal or artificial level.[57]

Creeping takeover by means of swaps. Depending on the governing law (with the home Member State of the regulated market as the connecting factor),[58] the acquirer may be able to manage both the cost of the takeover and the adverse effect of disclosure rules by using derivatives. This method can be illustrated by the attempted takeover of Volkswagen by Porsche and the attempted takeover of Continental by Schaeffler. The purchase by IFIL and Exor of shares in Fiat raises further questions.

Porsche. Before acquiring a controlling block of shares in Volkswagen AG, Porsche applied a creeping takeover method.

Porsche took an 18% stake in September 2005 and built its stake to 31%. This triggered an obligation to make a mandatory bid. Porsche made a mandatory bid but stressed it did not want to get a majority stake.[59] Porsche offered the lowest price it could according to the applicable rules, and few shareholders accepted the offer. In 2008, Porsche decided to take its holding above 50%.

Porsche had regulated the cost of the acquisition by options on VW's shares. The options could be swapped into shares at any given time but were settled in cash. Cash-settled options qualified for compensation between the price that was locked in and the actual share price.

Now, in an equity swap, the "long" side receives from the "short" side an economic return equivalent to the return on the underlying shares. A party that takes a "short" equity swap position typically hedges its position, and one of the ways to do it is to buy shares long. As the price of VW's shares soared due to increasing demand and anticipated demand, Porsche made windfall profits from its derivatives business. In order to secure control, Porsche still had to actually buy VW shares. However, Porsche had hedged its position against rising share price.

The creeping takeover strategy employed by Porsche was partly made possible by the absence of a duty to disclose positions in cash-settled derivatives under Community and German law. The Transparency Directive which requires the dis-

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[54] Article 19(1)(a) of Directive 77/91/EEC (Second Company Law Directive).

[55] Article 19(1) of Directive 77/91/EEC (Second Company Law Directive).

[56] Article 5 of Directive 2003/6/EC (Directive on market abuse).

[57] Article 1(2) of Directive 2003/6/EC (Directive on market abuse).

[58] Articles 36(4) and 4(1)(20)(b) of Directive 2004/39/EC (MiFID).

[59] Porsche AG, Porsche schließt Pflichtangebot ab, Pressemitteilung, 4 June 2008. Less than 1% of shares were traded.

closure of major shareholdings[60] does not require the disclosure of cash-settled call options.

There are stricter disclosure obligations in Switzerland and the UK. In July 2008, the Financial Services Authority (FSA, the UK regulatory authority) decided that share and derivatives ("contracts for difference") holdings in the same company should be aggregated for disclosure purposes. The threshold was set at 3%. In contrast, the SEC is strictly against the adoption of similar disclosure obligations in the US.

Schaeffler. The Porsche method was soon emulated by Schaeffler KG, a family-owned engineering group, when it tried to acquire Continental AG, a listed and far larger company. Schaeffler used swaps to fix the cost of the takeover in advance. In public, Schaeffler made statements that Schaeffler only aimed to achieve a minority position. In July 2008, Schaeffler made a public offer for Continental's shares and offered to pay the lowest legally possible price.

Continental argued that the methods used by Schaeffler were illegal.[61] In August 2008, the BaFin nevertheless stated that it had not identified any breaches of reporting requirements in Continental AG takeover procedure.

First, Schaeffler had been under no obligation to make a mandatory bid. Only those who acquired at least 30% of the *voting rights* of a quoted company were required to make a mandatory offer to the other shareholders under the German Securities Acquisition and Takeover Act (WpÜG).[62] The Directive on takeover bids does not require the making of a mandatory bid unless a person actually holds shares that give voting rights. The mere securing of option rights will therefore not trigger a duty to make a mandatory bid.[63] Furthermore, the making of a voluntary bid can exempt the offeror from the obligation to make a mandatory bid.[64]

Second, Schaeffler did not have a duty to disclose major holdings under the Securities Trading Act (WpHG) according to which *voting rights* reports had to be filed as soon as the reporting thresholds were reached. Schaeffler owned just under 3% of Continental's shares before the announcement of the takeover bid. It had built up a cash-settled total return equity swap for around 28% of Continental's shares between March and May 2008, but this was a *contract for difference*, under which two parties bet on prices rising or falling. Such contracts are not intended to involve the actual delivery of shares but are settled by means of a cash payment of the difference. The shares underlying the swap agreement could, therefore, have been attributed to Schaeffler only if BaFin had been able to prove the existence of further agreements under which: (a) its counterparty (Merrill Lynch International) or third parties had held Continental shares on behalf of

[60] Article 9(1) of Directive 2004/109/EC (Transparency Directive).

[61] Continental AG, press release of 30 July 2008. They were also criticised by professor Habersack M of the University of Tübingen. See also Zetzsche DA, Continental AG vs. Schaeffler, Hidden Ownership and European Law - Matter of Law or Enforcement? CBC-RPS No. 0039 (October 2008).

[62] § 35 and § 29(2) WpÜG.

[63] Article 5(1) of Directive 2004/25/EC (Directive on takeover bids).

[64] Article 5(2) of Directive 2004/25/EC (Directive on takeover bids).

Schaeffler;[65] (b) Schaeffler had been able to acquire Continental shares as a result of a declaration of intent;[66] or (c) voting rights were to be exercised jointly.[67] BaFin was unable to find evidence of any such agreements. For instance, BaFin had not been able to establish that Merrill Lynch had been acting as coordinator of swap agreements for Schaeffler or that shares acquired as cover were to be delivered in any subsequent takeover bid (for concerted action, see below).[68]

Third, the swap agreement had not created any reporting requirement for Schaeffler in respect of holding other financial instruments,[69] since the cash-settled total return equity swap conveyed no claim to delivery of Continental shares. The only financial instruments which were reportable for the purposes of the Securities Trading Act were those which entitled the holder of the financial instrument to unilaterally acquire shares with voting rights attached that had already been issued.

Fourth, the BaFin did not find any grounds for believing that Merrill Lynch had breached voting rights reporting requirements.

As a result, Continental AG, Schaeffler KG, and the partners of Schaeffler KG agreed on the terms of Schaffler's investment.[70] Schaeffler KG agreed to increase the offer price. The Investment Agreement, which could not be terminated by the parties before spring 2014, contained terms to safeguard the interests of Continental AG and its shareholders, employees and customers. Schaeffler undertook to limit its position to a minority shareholding in Continental AG (up to 49.99%) for a period of four years. Furthermore, Schaeffler agreed to compensate Continental AG for possible negative effects caused by change-of-control clauses in the existing financing agreements of Continental AG and for negative tax effects resulting from Schaeffler's shareholding.

Word of warning. Both Porsche and Schaeffler still had to finance their share buys and option deals. During the financial crisis, this became increasingly difficult. Schaeffler ended up being taken over by the much larger target company.

IFIL and Exor. Fiat is controlled by IFIL which in turn is controlled by the Agnelli family. In 2005, Fiat announced it would not repay in cash a €3 billion convertible loan from a consortium of banks. This meant that IFIL risked losing control of Fiat. IFIL nevertheless intended to keep control.

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65 § 30(1) sentence 1 nr 2 WpÜG, § 22(1) sentence 1 nr 2 WpHG.

66 § 30(1) sentence 1 nr 5 WpÜG, § 22(1) sentence 1 nr 5 WpHG.

67 § 30(2) WpÜG, § 22(2) WpHG.

68 See also Fehr B, Jahn J, Mit Swap-Geschäften zum Übernahmeerfolg, FAZ, 9 August 2008, p 13: "Der Clou der Konstruktion liegt darin, dass die Bank genau am Ende der Laufzeit die zu Absicherungszwecken erworbenen Conti-Aktien verkaufen muss, wenn sie alle Kursrisiken ausschalten will. Wie sich dem Prospekt entnehmen lässt, hat Schaeffler vor, das Ende der Swap-Laufzeit genau auf das Ende des Übernahmegebots zu legen. Prinzipiell steht es der Bank dann frei, an wen und zu welchem Kurs sie ihre Aktien verkauft. Doch spricht einiges dafür, dass es für die Bank dann wirtschaftlich sinnvoll sein wird, die Wertpapiere Schaeffler anzudienen."

69 § 25(1) WpHG.

70 Schaeffler KG and Continental AG, press releases of 21 August 2008.

This created a dilemma. When the banks converted their loans into shares, IFIL might have to buy more shares, probably at a premium, to avoid losing control of Fiat. But if IFIL increased its holding, it might have to make a mandatory bid for the remaining shares in cash, something the Agnellis could not afford to do.

IFIL solved the problem by buying enough shares from Exor, its sister company, to retain control on the day the banks converted their loans into shares. Exor in turn received the shares on the same day from Merrill Lynch under a prior equity swap. According to its original terms, the swap was to be settled in cash; on the settlement day, however, the parties agreed on physical delivery. Was the transaction in fact a call option from the beginning (which could have triggered a duty to make a mandatory bid) or a cash-settled contract for difference (which would not have had such an effect)? The CONSOB, the Italian securities regulator, believed that it was a case of the former.[71]

19.4 Selective Disclosure Internally

The main rule is that it is prohibited to disclose inside information selectively. However, internal decision-making requires selective disclosure. In practice, the issuer can benefit from exemptions that apply to selective disclosure and internal decision-making under the Directive on market abuse.

Inside information. Inside information is a broad concept. For example, information can be "of a precise nature" and inside information even where information concerns a process which occurs in stages. Each stage of the process as well as the overall process could be information of a precise nature.[72] Information about the internal decision-making of the acquirer can thus be inside information and information disclosed selectively by a corporate body to another corporate body or managers inside the firm in the course of this process can also be inside information.

Permitted disclosure. Generally, selective disclosure to a *third party* is not prohibited under the Directive on market abuse when it is made to a person "in the normal course of the exercise of his employment, profession or duties" and will not trigger a duty to make the information public if the person receiving the information owes a duty of *confidentiality*.[73]

Disclosure to the issuer's *own people* is in effect governed by a similar *confidentiality* requirement.[74] The issuer must also: establish effective arrangements to ensure that only those who require inside information for the exercise of their

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[71] Still in the driving seat, The Economist, October 2005. For legal proceedings that resulted from this case, see Zetzsche DA, Continental AG vs. Schaeffler, Hidden Ownership and European Law - Matter of Law or Enforcement? CBC-RPS No. 0039 (October 2008). Available at SSRN.

[72] CESR, Market Abuse Directive. Level 3 – second set of CESR guidance and information on the common operation of the Directive to the market (July 2007).

[73] Articles 6(3) and 3(a) of Directive 2004/25/EC (Directive on takeover bids).

[74] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).

functions within the issuer gain access to inside information; and take the necessary measures to ensure that any person with access to inside information information acknowledges the legal and regulatory duties entailed and is aware of the sanctions attaching to the abuse or improper circulation of such information.[75]

The confidentiality requirement is complemented by the *legitimate interest* requirement. The issuer can have a legitimate interest for delaying public disclosure although information is disclosed internally. For example, the reason can be the separation of decision management and decision control. The issuer can have a two-tier board structure and the decision of a management body may have to be ratified by the supervisory body.[76] – This can be contrasted with the decision rights of the general meeting which do not give a legitimate interest for delaying public disclosure. A proposal submitted to the general meeting cannot be held confidential because it must be made available to a large number of shareholders.

Confidentiality obligations. The Directive on market abuse does not regulate confidentiality obligations as such apart from the duties of primary or secondary insiders.[77] Confidentiality obligations are therefore based on Member States' laws and can vary depending on the firm and the governing law.

In *Germany*, mimimum confidentiality obligations based on the Directive[78] are complemented by a broader requirement of secrecy which follows from general company law provisions (duty of care, secrecy)[79] and the general provisions of the law of obligations for members of the two boards and the advisers to whom they pass on information.[80] When the management board of a German AG discloses information about a bid to the supervisory board as part of its duties,[81] members of the supervisory board receive it in the normal course of the exercise of their own duties.[82] The duty of confidentiality owed by the members of the supervisory board to the company[83] is enough not to trigger mandatory disclosure under the Directive on market abuse.

In *England*, personal and disclosure-delaying confidentiality obligations can exist on a number of grounds.[84] A person can owe fiduciary duties based on the general law which relies on civil remedies.[85] However, the City Code, which regulates takeover bids and certain other transactions, requires *secrecy* before the announcement of the bid.[86] Even rumours may trigger a duty to make an announcement under the City Code.[87] The City Code re-

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75 Article 3(2) of Directive 2003/124/EC.

76 Article 3(1) of Directive 2003/124/EC. See also DTR 2.5.3 R.

77 Articles 2, 3 and 4 of Directive 2003/6/EC (Directive on market abuse).

78 § 14 WpHG.

79 § 93(1) and § 116 AktG.

80 See Hopt KJ,Takeovers, Secrecy, and Conflicts of Interest: Problems for Boards and Banks (October 2002). ECGI - Law Working Paper No. 03/2002. Available at SSRN.

81 § 90 AktG.

82 § 111(1) AktG.

83 § 116 AktG.

84 See also DTR 2.5.1 Rule.

85 Percival v Wright [1902] 2 Ch 421; Schering Chemicals Ltd v Falkman Ltd [1982] QB 1. This can be contrasted with the Criminal Justice Act 1993 which makes insider dealing a criminal offence. Section 52(1) of the Criminal Justice Act 1993.

86 Rule 2.1 of the City Code on Takeovers and Mergers.

87 Rule 2.2 of the City Code on Takeovers and Mergers.

quires an announcement already when "negotiations or discussions are about to be extended to include more than a very restricted number of people (outside those who need to know in the companies concerned and their immediate advisers)."

Pursuing the acquisition. Supply and demand will influence the price of securities. One might therefore ask whether a party may buy or sell a large block of shares knowing that such dealings will influence share price. The answer is yes, provided that the share price is not influenced artificially (manipulated).[88] A distinction is made between the prior decision to buy or sell on one hand and the carrying out of the acquisition or disposal on the other. The preamble of the Market Abuse Directive implies that the carrying out of the acquisition or disposal should not be deemed in itself to constitute the use of inside information[89] – as that information can be inside information only provided that no party has made it public, failure to disclose it will not change the result.

19.5 Selective Disclosure to Lenders

The Directive on market abuse does not prohibit the selective disclosure of inside information to holders of unregulated loans or prospective lenders, provided that the person making the disclosure makes it "in the normal course of the exercise of his employment, profession or duties".[90] Such a disclosure can trigger a duty to make a public disclosure according to the Market Abuse Directive, unless the person receiving the information owes a duty of confidentiality.[91] In addition, some issuers of debt instruments may have undertaken a contractual duty to disclose information to the public.[92]

19.6 Selective Disclosure to Outsiders by the Acquirer

For many reasons, it is in the interests of the potential acquirer to ensure selective exchange of information, keep such information confidential, and delay making its intentions known to the public. Selective disclosures are necessary internally for reasons of information-gathering and because a company must take care of its internal decision-making. The potential acquirer will also need to exchange information selectively with third parties when it arranges financing, organises a consor-

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[88] Article 5 of Directive 2003/6/EC (Directive on market abuse). See also Directive 2003/124/EC.

[89] Recital 30 of Directive 2003/6/EC (Directive on market abuse).

[90] Article 3(a) of Directive 2003/6/EC (Directive on market abuse).

[91] Article 6(3) of Directive 2003/6/EC (Directive on market abuse).

[92] See, for example, EHYA and LMA Recommended Market Market Practices, Disclosure by Issuers of of Non-Investment Grade Debt Securities (June 2008); CESR, Consultation Paper, Transparency of corporate bond, structured finance products and credit derivatives markets (December 2008).

tium, and obtains advise at the various stages of its decision-making. The acquisition could be frustrated if the potential acquirer had to disclose each of its early steps to the public or if information about its plans leaked out to the public. The acquirer may nevertheless have such a duty if its shares have been admitted to trading on a regulated market.[93]

Selective disclosure. The Directive on market abuse prohibits certain forms of selective disclosure of inside information to outsiders.[94] There is a disctinction between making recommendations and other forms of disclosure.

An issuer's managers and many other people[95] who possess inside information are prohibited from "recommending or inducing another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates".[96] For obvious reasons, it is irrelevevant whether that person owes a duty of confidentiality or not.[97]

As regards other forms of selective disclosure, a manager is prohibited from "disclosing inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties".[98]

In *England*, the categories of recipient who need information to perform their functions include, for example, the following: (a) the issuer's advisers and advisers of any other persons involved in the matter in question; (b) persons with whom the issuer is negotiating, or intends to negotiate, any commercial financial or investment transaction (including prospective underwriters or placees of the financial instruments of the issuer); (c) employee representatives or trade unions acting on their behalf; (d) any government department or any statutory or regulatory body or authority; (e) major shareholders of the issuer; (f) the issuer's lenders; and (g) credit-rating agencies.[99]

Public disclosure. Such a selective disclosure will trigger a duty to disclose inside information to the public unless the issuer has a legitimate interest for delaying disclosure, the issuer can ensure confidentiality, and delaying disclosure would would not be likely to mislead the public.[100]

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93 Article 6(1) of Directive 2003/6/EC (Directive on market abuse).

94 See also DTR 2.2.10 G: "The FSA is aware that many issuers provide unpublished information to third parties such as analysts, employees, credit rating agencies, finance providers and major shareholders, often in response to queries from such parties. The fact that information is unpublished does not in itself make it inside information. However, unpublished information which amounts to inside information is only permitted to be disclosed in accordance with the disclosure rules and an issuer must ensure that at all times it acts in compliance with this chapter."

95 See Articles 2(1), 2(2) and 4 of Directive 2003/6/EC (Directive on market abuse).

96 Article 3(b) of Directive 2003/6/EC (Directive on market abuse).

97 See Article 6(3) of Directive 2003/6/EC (Directive on market abuse).

98 Article 3(a) of Directive 2003/6/EC (Directive on market abuse).

99 DTR 2.5.7 G (2).

100 Article 6(2) of Directive 2003/6/EC (Directive on market abuse).

On-going negotiations can provide a legitimate interest for delaying disclosure to the public.[101] Ensuring confidentiality after a permitted form of selective disclosure will typically require the use of non-disclosure obligations or the existence of statutory confidentiality obligations.[102] In the takeover context, the issuer's permanent company-specific insider list required by the Market Abuse Directive must be complemented by a project-specific insider list.[103]

Disclosure is neither selective nor confidential when it is made to a large number or an unlimited group of people,[104] and disclosure is not selective just because it is made to people who owe a duty of confidentiality to the issuer. Even where disclosure is both selective and confidential, the existence of a large number of recipients will increase risk. The wider the group of recipients of inside information, the greater the likelihood of a leak which will trigger full public disclosure under the Directive on market abuse.[105]

The City Code requires an announcement already when "negotiations or discussions are about to be extended to include more than a very restricted number of people (outside those who need to know in the companies concerned and their immediate advisers)". Furthermore, the City Code provides that "an offeror wishing to approach a wider group, for example in order to arrange financing for the offer, to seek irrevocable commitments or to organise a consortium to make the offer should consult the Panel".

19.7 Selective Disclosure to Outsiders by the Target

Whether the target company is prevented under the Directive on market abuse from disclosing inside information selectively to the potential acquirer or offeror is a matter of interpretation and depends on the scope of the Directive.

Inside information. First, the Directive on market abuse does not cover the use or disclosure of information that is not regarded as "*inside information*".[106] The Directive thus only requires the issuer to keep *price-sensitive* information secret.[107]

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[101] Articles 6(2) and 6(3) of Directive 2003/6/EC (Directive on market abuse) and Article 3(1)(a) of Directive 2003/124/EC.

[102] Articles 6(2) and 6(3) of Directive 2003/6/EC (Directive on market abuse). See also Article 5(5) of Directive 2004/72/EC: "Member States shall ensure that the persons required to draw up lists of insiders take the necessary measures to ensure that any person on such a list that has access to inside information acknowledges the legal and regulatory duties entailed and is aware of the sanctions attaching to the misuse or improper circulation of such information."

[103] See Article 5(1) of Directive 2004/72/EC: "… on a regular or occasional basis".

[104] An offer of securities addressed to fewer than 100 persons per Member State will not trigger an obligation to publish a prospectus according to Article 3(2)(b) of Directive 2003/71/EC (Prospectus Directive).

[105] See also DTR 2.5.9 G.

[106] Article 1(1) of Directive 2003/6/EC (Directive on market abuse).

[107] Articles 3 and 1(1) of Directive 2003/6/EC (Directive on market abuse).

Neither does the Directive prohibit the use of such information by the acquirer generally. For example, not all forms of buyer due diligence are prohibited.

Public disclosure. Second, the Directive does not prevent the *simultaneous* disclosure of inside information to the *public* and selectively as such information ceases to be inside information.[108] Again, the Directive does not prohibit the use of information disclosed in such a way.[109]

Public change of control transactions. Third, there can be one or two exemptions that apply to public change of control transactions that have been regulated otherwise.

The disclosure of information to the target's shareholders and the public is regulated not only by the Market Abuse Directive but even by the Directive on takeover bids and national takeover laws as well as EU merger directives. The preamble of the Market Abuse Directive implies that their provisions can prevail over the provisions of the Market Abuse Directive.[110]

It is therefore: (1) fairly certain that the prohibition to disclose, recommend or induce will not prohibit disclosures to the extent that a restrictive interpretation of the Market Abuse Directive is necessary to give effect to other instruments of Community law; (2) likely that the prohibition to disclose, recommend or induce will not prohibit disclosures to the extent that they are necessary to comply with takeover or merger laws; and (3) possible that the prohibitions will not apply to disclosures which are objectively necessary before a public takeover or merger can take place.

Furthermore, the prohibition to use inside information may not apply where the acquirer trades in shares only in the capacity of offeror or merger party and in that context. It is also stated in the preamble that "[h]aving access to inside information relating to another company and using it in the context of a public take-over bid for the purpose of gaining control of that company or proposing a merger with that company should not in itself be deemed to constitute insider dealing".[111]

Both exemptions can be explained by the need to ensure internal coherence of Community law. In addition, permitting due diligence can make European takeovers easier. Member States may have adopted a more detailed and stricter disclosure regime.

No other exemptions. The Directive on market abuse does not explicitly provide for any other exemptions. There is thus a prohibition to disclose inside information. Selective disclosure without sufficient confidentiality will trigger a mandatory disclosure obligation. A party that has received inside information must not use it "by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates".[112]

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[108] Article 6(1) of Directive 2003/6/EC (Directive on market abuse).

[109] For US law, see already In the Matter of Cady, Roberts & Company.

[110] Recital 28 of Directive 2003/6/EC (Directive on market abuse): "… public take-over bid or other proposed change of control …"

[111] Recital 29 of Directive 2003/6/EC (Directive on market abuse).

[112] Article 2(1) of Directive 2003/6/EC (Directive on market abuse).

Due diligence. The absence of other exemptions makes one ask whether the target can permit buyer due diligence and whether the acquirer can use inside information disclosed to it in the course of due diligence.

Due diligence, disclosure. The main rule is that disclosure of inside information is prohibited. The whole purpose of permitting buyer due diligence in a share deal is to "induce" the acquirer to acquire shares on the basis of information disclosed.[113] If this were not the purpose of permitting buyer due diligence, the people responsible for permitting it would be likely to breach their fiduciary duties, duty of care, or similar duties owed to the target company.

Due diligence, use of inside information. Does the prohibition to use inside information prevent the parties from completing the transaction where inside information has been disclosed earlier in the course of due diligence?

The answer can depend on what the potential acquirer will do. Information might be disclosed to: (1) a potential acquirer who decides not to pursue the acquisition; (2) a potential acquirer who decides to pursue the acquisition; (3) a potential acquirer who makes a public takeover bid or a merger offer; or (4) a potential acquirer who makes an offer to a small group of shareholders.

Furthermore, one can distinguish between different situations depending on the knowledge level of the potential acquirer's contract party: inside information will not be in the possession of the other party or parties; inside information will be disclosed to the other party or parties before the offer is made; or inside information will be disclosed when the offer is made.

Walking away. From the perspective of the potential acquirer, it is not prohibited to use inside information by not buying or not selling securities.[114] A party can thus walk away from the deal without breaching insider trading rules.

Selective offers. On the other hand, the potential acquirer might prefer to complete the transaction by making a selective offer designed to lead to a privately negotiated transaction between a small number of parties. The exemption discussed above does not cover selective offers - neither a public takeover bid nor a merger offer can be selective.[115] Do the rules on inside information apply to selective offers?

The wording of the Directive on market abuse does not expressly permit any exemption in this case. On the contrary, it implies that it is not the purpose of the Directive to favour selective offers.

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[113] In Case C-27/02 Engler [2005] ECR I-481, paragraph 61, the ECJ said that one form of "inducing" a consumer to enter a contract is to address to him in person a letter of such a kind as to give the impression that a prize will be awarded to him if he returns the "payment notice" attached to the letter and accepts the conditions laid down by the vendor. In Case C-304/02 Commission v France, the Court considered that the sanctions provided by the EC Treaty have a common objective of "inducing" a defaulting Member State to comply with a judgment establishing a breach of obligations.

[114] Article 2(1) of Directive 2003/6/EC (Directive on market abuse).

[115] See Article 3(1)(a) of Directive 2004/25/EC (Directive on takeover bids) and Article 42 of Directive 77/91/EEC (Second Company Law Directive).

The purpose of the prohibition of abuse of inside information is "to ensure the integrity of Community financial markets and to enhance investor confidence in those markets".[116] The prohibition is designed to increase "full and proper market transparency, which is a prerequisite for trading for all economic actors in integrated financial markets".[117] It is simply not the purpose of the Directive to enhance transparency by permitting selective disclosure.[118] Basically, all securities market transactions are designed to give information about the issuer and the valuation of its securities, and price is an important mechanism to signal the quality of securities (see the chapter on information management in Volume I).

This could mean that the *disclosure* of inside information to the potential acquirer is subject to the usual restrictions (no recommending, no inducing, either confidentiality or public disclosure, see above)[119] and that the potential offeror must not *use* inside information by acquiring or disposing of financial instruments to which that information relates.[120]

Mutual dealings, Georgagis. This leads to the question of mutual dealings. Where the same inside information is in the possession of all parties to the transaction, no party will be able to abuse that inside information in their *mutual* dealings. That was the view of the ECJ in *Georgagis*.[121] The ECJ went even further and indicated that the parties in such a situation do not take advantage of inside information in relation to *any party*.[122] The judgment of the ECJ is believed to be correct,[123] but it raises doubts. There is a difference between being fair to a contract party and ensuring market integrity.

The difference between being fair to a contract party and being fair to all other people can be illustrated by two early US cases. *In the Matter of Cady, Roberts & Company* was a case about being fair to a contract party. According to the administrative opinion of SEC Chairman William Cary, an insider in possession of material nonpublic information must disclose such information before trading, or if disclosure is impossible or improper, must abstain from trading in that company's stock. In the case of *Texas Gulf Sulphur*, however, the Second Circuit Court of Appeals held that Rule 10b-5 was intended to ensure that "all investors trading on impersonal exchanges had relatively equal access to material information" and that all members of the investing public "should be subject to identical market risks".

In *Georgagis*, the ECJ took a very narrow view on the protection of investor confidence and market integrity partly because the ECJ interpreted the Insider Directive 89/592/EEC[124] rather than the present Market Abuse Directive. The Insider Directive had a narrower scope. For example, it did not contain any provisions on market manipulation.

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[116] Recital 12 of Directive 2003/6/EC (Directive on market abuse).
[117] Recital 15 of Directive 2003/6/EC (Directive on market abuse).
[118] For a critical approach to the prohibition of insider trading, see nevertheless Henry Manne, Insider Trading and the Stock Market. The Free Press, New York (1966).
[119] Article 3 of Directive 2003/6/EC (Directive on market abuse).
[120] Article 2(1) of Directive 2003/6/EC (Directive on market abuse).
[121] Case C-391/04 Georgakis [2007] ECR p I-3741, paragraphs 37–39.
[122] Case C-391/04 Georgakis [2007] ECR p I-3741, paragraph 39.
[123] See Moalem D, Lau Hansen J, Insiderhandel og informationsparitet – en analyse af EG-Domstolens afgørelse i Georgagis, NTS 2007:3 pp 22–46.
[124] Directive 89/592/EEC coordinating regulations on insider dealing.

The Directive on market abuse has a broader scope and is more ambitious than the Directive it replaced. This should limit the value of the judgment of the ECJ in Georgagis.

The fundamental purpose of the Directive on market abuse – reducing investors' perceived risk and transaction costs – requires more than reducing information asymmetries between two particular market participants. Investors' perceived risk can be reduced (meaning that the perceived market integrity can be increased) if investors generally believe that: issuers disclose all inside information to the public;[125] information disclosed to investors fulfils the requirement of generic usefulness (it is accurate, comprehensive and timely, see Volume I); all investors have access to the same information;[126] all investors act in the market for legitimate reasons (fairness, good faith) and the rule that a party must not deal on the basis of inside information or manipulate the market is enforced effectively. The purpose of the Directive on market manipulation will not be met if parties who possess inside information are permitted to use inside information in their mutual dealings but other market participants are kept in the dark; that would not increase "full and proper market transparency, which is a prerequisite for trading for all economic actors in integrated financial markets".[127]

19.8 Disclosure to the Public

Public disclosure of inside information may – in addition to Member States' laws – be required either by the main rule under the Directive on market abuse or by the provisions of the Directive on takeover bids.

Main rule. The main rule is that an issuer must disclose inside information when there is no longer a legitimate interest to delay disclosure, when the issuer can no more ensure confidentiality, or when delaying disclosure would be likely to mislead the public.[128]

This can be illustrated by *English* law. In England, DTR 2.5.4 G states that the rule on negotiations – DTR 2.5.3 R (1) – does not allow an issuer to delay public disclosure of the fact that it is in financial difficulty or of its worsening financial condition. DTR 2.5.3 R (1) is thus limited to the fact or substance of the negotiations to deal with such a situation. An issuer cannot delay disclosure of inside information on the basis that its position in subsequent negotiations to deal with the situation will be jeopardised by the disclosure of its financial condition.

Announcing a decision to make a bid. In addition to those general requirements, particular requirements apply in the context of public bids. A decision to make a bid must be communicated to the supervisory authority and made public without delay.[129] There can be differences depending on the Member State.

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[125] Article 6(1) of Directive 2003/6/EC (Directive on market abuse).

[126] Articles 1(1) and 6(1) of Directive 2003/6/EC (Directive on market abuse); Articles 4, 5 and 6 of Directive 2004/109/EC (Transparency Directive); Articles 68(1) and 21(1) of Directive 2001/34/EC (Listing Directive).

[127] Recital 15 of Directive 2003/6/EC (Directive on market abuse).

[128] Article 6(2) of Directive 2003/6/EC (Directive on market abuse).

[129] Article 6(1) of Directive 2004/25/EC (Directive on takeover bids).

According to the *German* WpÜG, the offeror has a duty to disclose a decision to make a public offer. If the offeror is an AG, it must be disclosed after both boards have accepted it. The main rule is that it is not permitted to wait for a resolution by the general meeting.[130]

The *City Code* on Takeovers and Mergers generally requires absolute secrecy before an announcement of the bid.[131] *Before* the board of the offeree company is approached, the responsibility for making an announcement lies with the offeror.[132] *Following* an approach to the board which may or may not lead to an offer, the primary responsibility for making an announcement will normally rest with the board of the offeree company.[133] A brief announcement that *talks* are taking place will normally suffice, until a *firm intention* to make an offer has been notified.[134] The offeree company must make an announcement "when a firm intention to make an offer … is notified to the board of the offeree company from a serious source, irrespective of the attitude of the board to the offer", and in certain other circumstances.[135] There may be a duty to make an announcement already where the company is the subject of *rumour or speculation*.[136]

Announcing the bid. After announcing the decision to make a public takeover bid, the offeror is required to announce the bid by drawing up and making public "in good time" an offer document.[137] Member States must ensure that a bid is made public "in such a way as to ensure market transparency and integrity for the securities of the offeree company, of the offeror or of any other company affected by the bid, in particular in order to prevent the publication or dissemination of false or misleading information".[138]

Under *German* law, the offeror must not announce the offer unless it has ensured that it will have the necessary funds at its disposal when consideration falls due.[139] According to the general principles of the *City Code*, an offeror "must announce a bid only after ensuring that he/she can fulfil in full any cash consideration if such is offered, and after taking all reasonable measures to secure the implementation of any other type of consideration".[140]

Prospectus. Although the Prospectus Directive and implementing legislation require the issuer to publish a prospectus when securities are offered to the public, many of the exemptions under the Directive apply in a takeover context. For example, there are exemptions that apply when securities are offered in connection with a takeover by means of an exchange offer (section 5.9.3).

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[130] § 10(1) WpÜG.
[131] Rule 2.1 of the City Code on Takeovers and Mergers.
[132] Rule 2.3 of the City Code on Takeovers and Mergers.
[133] Rule 2.3 of the City Code on Takeovers and Mergers.
[134] Rule 2.4 of the City Code on Takeovers and Mergers.
[135] Rule 2.2 of the City Code on Takeovers and Mergers.
[136] Rule 2.2 of the City Code on Takeovers and Mergers.
[137] Article 6(2) of Directive 2004/25/EC (Directive on takeover bids).
[138] Article 8(1) of Directive 2004/25/EC (Directive on takeover bids).
[139] § 13(1) WpÜG. See Riegger B, Kapitalgesellschaftsrechtliche Grenzen der Finanzierung von Unternehmensübernahmen durch Finanzinvestoren, ZGR 2008 p 234.
[140] General Principle 5 of the City Code on Takeovers and Mergers.

19.9 Acting in Concert, Acting in a Certain Capacity

The capacity in which a party acts influences the application of disclosure and other rules and the prohibition of insider trading. Parties can act as one party (in concert) or as separate parties, and a party can act on behalf of another party or on its own behalf.

Acting in concert. When parties act in concert, many obligations will be applied as if the parties were one party, or actions by one party are attributed to many parties.

Depending on the context, provisions on acting in concert are based on different Community law instruments. They include, in particular, the Transparency Directive (disclosure of major holdings[141]), the Directive on takeover bids (disclosure of control structures,[142] duty to make a mandatory bid,[143] the price paid for the shares by the offeror or by persons acting in concert with the offeror,[144] disclosure in the offer document of the identity of persons acting in concert with the offeror[145]), and EU competition law (prohibition of concerted practices which restrict competition,[146] acquisition of joint control).

What acting in concert means depends on the context.[147] For example, what is regarded as acting in concert in the context of the disclosure of major holdings (when it triggers a mere disclosure obligation) does not have to be the same thing as acting in concert in the context of mandatory bids (when it triggers a duty to make a bid and pay a higher price) or in the context of the acquisition of joint control.

It is unclear to what extent those provisions of Community law are interrelated.[148] There is US literature[149] and case-law on the tension between antitrust laws and securities regulation, and there are rules for "implied revocation of the antitrust laws in the field of securities regulation".[150]

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[141] Articles 10 and 13(1) of Directive 2004/109/EC (Transparency Directive).
[142] Article 10 of Directive 2004/25/EC (Directive on takeover bids).
[143] Article 5(1) of Directive 2004/25/EC (Directive on takeover bids).
[144] Article 5(4) of Directive 2004/25/EC (Directive on takeover bids).
[145] Article 6(3) of Directive 2004/25/EC (Directive on takeover bids).
[146] Article 81(1) of the EC Treaty.
[147] Fleischer H, Finanzinvestoren im ordnungspolitischen Gesamtgefüge von Aktien-, Bankaufsichts- und Kapitalmarktrecht, ZGR 2008 pp 196–199 and 204.
[148] See *ibid*, p 223.
[149] See, for example, Rock EB, Antitrust and the Market for Corporate Control, Cal L R 77 (1989) pp 1365–1428.
[150] Finnegan v. Campeau Corp., 915 F.2d 824 (2d Cir. 1990): "The three seminal Supreme Court cases, Silver v. New York Stock Exchange, 373 U.S. 341, 83 S.Ct. 1246, 10 L.Ed.2d 389 (1963), Gordon v. New York Stock Exchange, 422 U.S. 659, 95 S.Ct. 2598, 45 L.Ed.2d 463 (1975), and United States v. National Association of Securities Dealers, 422 U.S. 694, 95 S.Ct. 2427, 45 L.Ed.2d 486 (1975), establish the rules for implied revocation of the antitrust laws in the field of securities regulation."

Acting in concert and the mandatory bid: the Deutsche Börse case. The Deutsche Börse case shows how acting in concert can influence the duty to make a mandatory bid.

In 2005, a group of activist shareholders led by The Children's Investment Fund (TCI), a London hedge fund, prevented Deutsche Börse AG from taking over London Stock Exchange (LSE) and succeeded in ousting the chairman of Deutsche Börse's management board and reshuffling its supervisory board.

Now, according to German law, a mandatory bid must be made where a shareholder holds 30% of the voting rights. The same rules apply where different shareholders coordinate their conduct (concerted action). The BaFin inspected whether TCI and Atticus Capital, another hedge fund, were acting in concert and had a duty to make a mandatory bid. However, no evidence of concerted action could be found. According to rules that applied at the time, concerted action was basically limited to the use of voting rights.[151]

This led to a change of law. The definition of "acting in concert" was extended by the Risk Limitation Act (Risikobegrenzungsgesetz) to cover a wider range of situations.[152] There is "acting in concert" for example where two or more parties "cooperate in a manner capable of influencing the issuer's entrepreneurial orientation persistently or to a material extent".[153] Although one-off cases are exempted,[154] the broad definition of acting in concert may force parties sharing the same interests to coordinate their actions in order not to exceed the threshold of 30%.[155]

The *City Code* on Takeovers and Mergers defines acting in concert as follows: "Persons acting in concert comprise persons who, pursuant to an agreement or understanding (whether formal or informal), co-operate to obtain or consolidate control … of a company or to frustrate the successful outcome of an offer for a company. A person and each of its affiliated persons will be deemed to be acting in concert with each other." Certain categories of persons are presumed to be acting in concert unless the contrary is established.[156] Under the Disclosure and Transparency Rules (DTR) attached to the Listing Rules, a person will also be an indirect holder of shares held by a third party where they agree that they

[151] For the applicable rules, see, for example, Barry S, Bracht H, Casper M, Agreements on voting conduct in the election of the supervisory board (Aufsichtsrat) as Case for a Mandatory Offer - Case Note on OLG München of 27 April 2005, German L J, December 2005.

[152] § 22(2) WpHG and § 30(2) WpÜG.

[153] § 30(2) WpÜG: "… ausgenommen sind Vereinbarungen in Einzelfällen. Ein abgestimmtes Verhalten setzt voraus, dass der Bieter oder sein Tochterunternehmen und der Dritte sich über die Ausübung von Stimmrechten verständigen oder mit dem Ziel einer dauerhaften und erheblichen Änderung der unternehmerischen Ausrichtung der Zielgesellschaft in sonstiger Weise zusammenwirken ..."

[154] § 30(2) WpÜG and BGHZ 169, 98 (BGH II ZR 137/05).

[155] See, for example, Süßmann R, Das „Risikobegrenzungsgesetz" schafft neue Risiken, FAZ, 10 October 2007 p 23.

[156] The City Code on Mergers and Acquisitions, Definitions Section.

should adopt, by concerted exercise of the voting rights they hold, a lasting common policy towards the management of the company in question.[157]

Acting on behalf of another party. When a party (A) acts on behalf of another party (B), the actions of A can be attributed to B as well. Furthermore, the exemptions applicable to B can be extended to cover the actions of A.

For example, a party who possesses inside information is prohibited from using that information "by acquiring or disposing of … for the account of a third party, either directly or indirectly, financial instruments to which that information relates".[158] The main rule is that it does not matter whether A acts for its own account or on behalf of B. However, where B has made plans to launch a public takeover bid, B can benefit from the bidder exemption and buy shares before announcing the bid (see above). Where A acts on behalf of B, even A can indirectly benefit from the bidder exemption.

In contrast, where A does not act for the account of B but in another capacity, similar purchases can fall within the scope of the prohibition regardless of whether B benefits from any exemption or not. This can be illustrated by the prohibition of "warehousing". Warehousing means that a potential bidder tips a small group of related investors about its intention to bid for a specific target company based on the understanding that they will tender their holding to the bidder once the bid is made public. This group thus "warehouses" the shares for the bidder in exchange for the takeover premium. In the US, the practice of warehousing is prohibited under Rule 14e-3(a) of the SEC.[159]

19.10 Public Takeover Offers

As its name implies, the Directive on takeover bids applies to public takeover offers. The Directive regulates the international jurisdiction of supervisory authorities and questions of governing law,[160] sets out general principles,[161] and regulates many detailed duties.

The general principles have been listed in Article 3(1) of the Directive: "For the purpose of implementing this Directive, Member States shall ensure that the following principles are complied with: (a) all holders of the securities of an offeree company of the same class must be afforded equivalent treatment; moreover, if a person acquires control of a company, the other holders of securities must be protected; (b) the holders of the securities of an

[157] DTR 5.2.1 R.
[158] Article 2(1) of Directive 2003/6/EC (Directive on market abuse).
[159] See Goshen Z, Parchomovsky G, On Insider Trading, Markets, and 'Negative' Property Rights in Information (September 2000). Fordham Law & Economics Research Paper No 06. Davies PL, The Take-over Bidder Exemption and the Policy of Disclosure. In: Hopt KJ, Wymeersch E, European Insider Dealing - Law and Practice. Butterworths, London (1991) p 254.
[160] Article 4 of Directive 2004/25/EC (Directive on takeover bids).
[161] Article 3(1) of Directive 2004/25/EC (Directive on takeover bids).

offeree company must have sufficient time and information to enable them to reach a properly informed decision on the bid; where it advises the holders of securities, the board of the offeree company must give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company's places of business; (c) the board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid; (d) false markets must not be created in the securities of the offeree company, of the offeror company or of any other company concerned by the bid in such a way that the rise or fall of the prices of the securities becomes artificial and the normal functioning of the markets is distorted; (e) an offeror must announce a bid only after ensuring that he/she can fulfil in full any cash consideration, if such is offered, and after taking all reasonable measures to secure the implementation of any other type of consideration; (f) an offeree company must not be hindered in the conduct of its affairs for longer than is reasonable by a bid for its securities."

The Directive on takeover bids sets out minimum requirements, and Member States may lay down additional conditions and provisions more stringent than those of the Directive for the regulation of bids.[162]

In *England*, the City Code on Mergers and Takeovers lays down a legal regime which is more stringent. It covers certain companies, certain transactions, and certain persons. (a) The Code applies to offers for companies and SEs which have their registered offices in the UK, the Channel Islands or the Isle of Man if any of their securities are admitted to trading on a regulated market in the UK or on any stock exchange in the Channel Islands or the Isle of Man. It can apply even to certain other companies. (b) The Code applies to takeover bids and merger transactions of the relevant companies, however affected. (c) It applies also to a range of persons in the context of takeovers or other matters that fall within its scope.

In *Germany*, the Securities Acquisition and Takeover Act (WpÜG) applies to "offers for the acquisition of securities which were issued by a target company and are admitted to trading on an organised market" Target companies are public limited-liability companies (AG, KGA) having their seat in Germany.

Both countries' laws set out how they will be applied when the company has its registered office or its shares have been admitted to trading on a regulated market in another Member State of the EEA.[163]

Disclosure. Both the offeror and the target company's board must disclose information to shareholders and employees (section 12.6). The offeror must draw up and make public in good time an offer document.[164] The board of the offeree company must draw up and make public a document setting out its opinion.[165]

Conditions. The offer document must state all the conditions to which the bid is subject.[166] Member States should lay down rules to cover the possibility of a bid's lapsing, the offeror's right to revise the bid, the possibility of competing bids for a

[162] Article 3(2) of Directive 2004/25/EC (Directive on takeover bids).
[163] See Article 4 of Directive 2004/25/EC (Directive on takeover bids).
[164] Articles 6 and 8 of Directive 2004/25/EC (Directive on takeover bids).
[165] Article 9(5) of Directive 2004/25/EC (Directive on takeover bids).
[166] Article 6(3)(h) of Directive 2004/25/EC (Directive on takeover bids).

company's securities, the disclosure of the result of a bid, the irrevocability of a bid, and the conditions permitted.[167]

As a rule, the offeror may need to use the same conditions as the conditions precedent to closing used in most acquisition agreements. Depending on the governing law, the conditions can therefore range from the availability of funding and the lack of material adverse change to the obtaining of regulatory permits and the obtaining of a certain minimum percentage of shares.

In *Germany*, the minimum percentage could be 75% or 51% of the share capital. 75% of the share capital enables a controlling shareholder to control the target company under a control and profit transfer agreement and to decide on the merger of the target company with the acquisition vehicle.[168]

The actual use of conditions may be constrained both by the governing law and market practice. For example, their use has been severely constrained in the UK, but not in the US. In both countries, there are particular limitations on the right to invoke a material adverse change condition.

According to the *City Code* on Takeovers and Mergers, the main rule is that pre-conditions to the bid are not permitted unless they involve official authorisations or regulatory clearances relating to the bid. This means that the bid must not normally be made subject to any financing conditions or pre-conditions (other that regulatory clearances).[169] The offeror should also use all reasonable efforts to ensure the satisfaction of any conditions or pre-conditions to which the offer is subject.[170]

It is nevertheless normal to include a material adverse change condition.[171] The right to invoke a material adverse change condition was tested in *WPP's bid for Tempus* in 2001.[172]

In August 2001, WPP Group plc owned a 22% stake in Tempus Group plc. WPP made a public offer for the remaining shares. The offer was subject to the following condition: "… no material adverse change or deterioration having occurred in the business, assets, financial or trading position or profits or prospects of any member of the wider Tempus Group ..." After the 9/11 terrorist attacks, WPP wanted to invoke the pre-condition, but there were constraints under the Code.[173]

The UK Takeover Panel ruled that a bidder seeking to rely on the condition must show that exceptional circumstances affecting the target have arisen and that they could not have been reasonably foreseen when the offer was announced. The effect of those circumstances

[167] Recital 22 of Directive 2004/25/EC (Directive on takeover bids).

[168] § 293(1) AktG and § 65 UmwG. See Riegger B, Kapitalgesellschaftsrechtliche Grenzen der Finanzierung von Unternehmensübernahmen durch Finanzinvestoren, ZGR 2008 p 234.

[169] Rule 13 of the City Code on Takeovers and Mergers.

[170] Rule 13.4(b) of the City Code on Takeovers and Mergers.

[171] Rule 13.4(a) of the City Code: "An offeror should not invoke any condition or pre-condition so as to cause the offer not to proceed, to lapse or to be withdrawn unless the circumstances which give rise to the right to invoke the condition or pre-condition are of material significance to the offeror in the context of the offer. The acceptance condition is not subject to this provision."

[172] Panel Statement 2001/15.

[173] Rules 2.7 and 13 of the City Code on Takeovers and Mergers.

must be adverse enough to strike at the heart of the purpose of the transaction in question. As a result, the Takeover Panel held WPP to its offer.

Some MAC clauses could be invoked during the subprime mortgage crisis. In August 2007, private-equity firms and lending banks successfully invoked MAC clauses to show that *Home Depot* had been materially adversely affected by the collapse of the American subprime mortgage sector.

There is no "certain funds" requirement[174] or, indeed, any restriction on the conditionality of the bid in the US under US federal law. However, there are restrictions on when they may be invoked. *IBP Inc. v. Tyson Foods, Inc*. is a leading case interpreting material adverse effect (MAE). The Delaware Court of Chancery surprised many when it ordered those two companies to complete a merger. The court held that a merger party would be entitled to exercise a standard MAE clause only when the other party had suffered a significant change in the long-term health of its business.[175]

Fairness opinions. The Directive on takeover bids neither mentions nor requires the use of external fairness opinions. Fairness opinions are nevertheless standard in takeovers (section 13.4). Some external opinions are required by provisions of company law in a company that issues shares, participates in a merger, or participates in a division.[176] The use of external fairness opinions is often based on market practice rather than law. It is a legal requirement according to the City Code on Takeovers and Mergers.[177]

Takeover defences. The Directive on takeover bids does not prohibit the use of takeover defences. However, there is a control mechanism. The target's board may take measures which may result in the frustration of the bid only with the prior consent of shareholders in general meeting (section 17.2).

Break-through rule. In principle, the Directive also provides for a break-through rule.[178] The purpose of the break-through rule is to ensure a level playing field, although multiple-vote shares and other structural takeover defences are popular in some but prohibited in other Member States. In practice, however, this rule is optional for the Member States and the playing field is not level (section 10.3.2).

Golden shares. The Directive is silent on "golden shares". The ECJ has prohibited golden-share type arrangements (sections 9.3.2 and 17.4).[179]

Squeeze-out right and sell-out right. If the bidder company has obtained 90% or 95% of the target company following a public takeover bid, it has a squeeze-out right. The squeeze-out right enables it to require all the holders of the remaining securities to sell those securities to it at a fair price. The result is that the bidder

[174] See § 13(1) WpÜG and General Principle 5 of the City Code on Takeovers and Mergers.

[175] IBP Inc. v. Tyson Foods, Inc., 2001 Del. Ch. LEXIS 81 (June 15, 2001).

[176] See Articles 10, 10a, 10b and 27 of Directive 77/91/EEC (Second Company Law Directive); Article 10 of Directive 78/855/EEC (Third Company Law Directive).

[177] For *English* law, see Rule 3 of the City Code on Takeovers and Mergers. For *French* law, see Chapters I and II of Title VI (Book II) of the General Regulation of the Autorité des marches financiers (AMF) regarding independent appraisers and appraisals.

[178] Article 11 of Directive 2004/25/EC (Directive on takeover bids).

[179] Cases C-367/98 Commission v Portugal, C-483/99 Commission v France, and C-503/99 Commission v Belgium.

will own 100% of the company. The bidder's actions will then not be constrained by minority shareholders' rights.[180] Minority shareholders have a sell-out right under the same circumstances.[181]

In practice, squeeze-out rights are often litigated. In Germany, practically all squeeze-out processes end up in the court. There is a small class of so-called "professional plaintiffs" (Berufskläger) who try to force the company to pay more legally or illegally.[182]

Mandatory bid. The Directive contains a mandatory bid rule and sets out the price and form of consideration.[183] However, the Directive is silent on the threshold triggering the duty to make a bid, and the mandatory bid rule does not apply where control has been acquired following a voluntary bid. Under the German WpÜG and the City Code, a mandatory offer is triggered at a threshold of 30%.[184]

US law. The contents of US law have been explained in numerous specialist articles and books.[185] The basic instrument for the regulation of tender offers in federal US law is the Williams Act of 1968 which amended the Securities Exchange Act 1934 by adding sections 13(d) and (e) and 14(d) and (e).[186] The states have adopted their own takeover statutes. The US model is directed towards the objective of providing full disclosure of information to the shareholders, when major changes of control occur in their companies, as well as a period of time (a 20-day period) which may be considered as sufficient for them to evaluate the bids and decide, free from coercion. According to case-law, the use of takeover defences is relatively free and governed by the business judgment rule. The duties of the board change in change of control transactions.

[180] Article 15 of Directive 2004/25/EC (Directive on takeover bids).
[181] Article 16 of Directive 2004/25/EC (Directive on takeover bids).
[182] Jahn J, Meist enden Aktionärsausschlüsse vor Gericht, FAZ, 23 October 2007.
[183] Article 5 of Directive 2004/25/EC (Directive on takeover bids).
[184] § 29 WpÜG; Rule 9.1 of the City Code on Takeovers and Mergers.
[185] See Cole J Jr, Kirman I, Takeover Law and Practice. In: PLI, Doing Deals 2008: Understanding the Nuts & Bolts of Transactional Practice. New York City (2008) pp 11–158.
[186] For an introduction and comparison of UK and US law, see Barboutis GO, Takeover Defence Tactics: Part I: The General Legal Framework on Takeovers, Comp Lawyer 20(1) (1999) pp 14–22.

20 Acquisition Finance

20.1 Introduction

Business acquisitions belong to the largest investments that the firm makes. Acquisition finance means the use of debt, equity and mezzanine instruments to achieve the firm's general strategic objectives and the firm's specific acquisition and refinancing objectives.

Basically, the acquirer can use the same types of funding as firms in general (release of capital, debt, shareholders' capital, mezzanine). Acquisition finance nevertheless has its own financial and legal characteristics.

Main financial and legal characteristics. Four things are characteristic of acquisition finance. First, acquisitions tend to be highly leveraged. Second, the acquirer wants to repay debts from the target's assets. Third, after restructuring, the entity that owns the target's assets will be responsible for the repayment of the debts. Fourth, in some jurisdictions, a public takeover offer may not be made public unless the offeror has ensured that it has the necessary funding.[1]

Acquisition finance typically involves the use of short-term bridge funding and longer-term financing following refinancing after the completion of the acquisition. The different steps of acquisition financing will also enable the firm to choose a financing mix and financial instruments that match various parties' exit plans. For example, refinancing and leverage can support share buybacks and the payment of special dividends in the short term and a trade sale or IPO in the longer term.

Particular legal characteristics. Basically, acquisition finance is subject to the same legal rules and the same legal constraints as funding transactions in general. In addition, there are some particular legal aspects that are characteristic of acquisition finance.

First, instead of one legal entity, there are two or more legal entities on the side of the firm that will raise funding. This means that financial transactions between those entities will be constrained by company law rules. For example, the acquirer will have to take into account legal constraints on financial assistance by the target company.

Second, the status of those legal entities will change during the course of the acquisition. After the completion of the acquisition, the target will be controlled by the acquirer. For example, legal constraints on financial assistance by the target company can be circumvented by refinancing the acquisition after its completion.

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[1] § 13(1) WpÜG and General Principle 5 of the City Code on Takeovers and Mergers.

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Third, funding can be raised by one or more of those legal entities. It is usual to employ a legal entity acting as a takeover vehicle. In a leveraged transaction, this entity will be highly leveraged.[2]

Fourth, the acquirer will have to coordinate the acquisition transaction and the funding transaction. One transaction influences the other.

Fifth, the questions of funding and exit are interrelated. The legal aspects of exit have been discussed in Chapters 8–10.

Form. The form of takeover finance can depend on many things. It can depend on *time*. The acquirer will need funding in the short term and in the long term. Short-term bridge financing will be replaced with longer-term financing after the completion of the acquisition.

It can depend on the *consideration* for the shares or assets bought. The acquirer may need to raise new external funding from investors if it makes a cash offer, but needs less funding from external investors if it pays by issuing its own shares to the seller (share offer).

Consideration for the shares or assets bought can depend on the *vendor*, because the main rule (from which there are exceptions especially in company law) is that the seller does not have any obligation to sell.

The form of takeover finance can depend on the *structure* of the acquisition. Typically, the assets or shares can be bought by the ultimate acquirer (A) directly or indirectly. In the latter case, another legal entity (B) is used as an acquisition vehicle. As the acquisition vehicle buys the assets or shares, it must raise funding. Part of it will come from the ultimate acquirer and other investors in the form of equity. The rest may be provided by lenders. If the acquisition vehicle buys shares in the target company (C), the two companies can merge, in effect leaving the target loaded with debt (B + C).

It can depend on the *acquirer*. A listed company may be able to raise funding from the stock market. A privately-owned company may have to raise funds through other means. In the case of a management buy-out, the managers themselves may need to borrow to finance their own purchase of shares in the takeover vehicle.

The form of funding can also depend on the *size* of the transaction. (a) A small-scale acquisition might simply be financed by bank borrowings. (b) If more substantial amounts of money are needed, the buyer might have to raise funds through other means. The buyer may issue shares and choose a mixture of debt and shareholders' finance. The shares may be ordinary shares or preference shares. The buyer may sometimes turn to a venture capital fund. (c) In a very large acquisition, venture capital funds may be joined by a syndicate of banks. Typically, the banks will provide the senior debt which will be secured and be honoured first if there are problems, and there will be some form of mezzanine finance.

And finally, it can depend on the *source* of funding. The most usual sources of funding are: the acquirer's existing assets; the acquirer's shareholders; the ac-

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[2] See, for example, Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 1 numbers 10–11.

quirer's lenders; the target or its assets; the target's owners; and the target's lenders.

Traditional categories of takeover financing. Different forms of takeover financing can be divided into different categories in many ways.

One can distinguish between three main categories of takeover financing: bridge loans; refinancing from banks and the capital market; and internal financing.[3] The fourth category is using the assets of asset investors.

Table 20.1 Forms of Takeover Financing (1)

Bridge loans:	Refinancing from the market:	Internal financing:	Assets of asset investors:
Revolving credit lines. Liquidity lines. Guarantees.	Loan facilities. Syndicated loans. Commercial paper. EMTM programmes Convertible bonds. Share issues. Asset securitisation.	Free cash flow of the acquirer. Free cash flow of the target. Disinvestments.	Securities lending.

The existence of different financing instruments increases flexibility and enables the acquirer to design a financing mix according to its needs.

One can also distinguish between different categories of takeover financing on the basis of availability. While some financial resources are available immediately or immediately after the completion of the acquisition, others are available in the medium or long term. The acquirer will need to review the availability of financial resources before committing to the acquisition.[4]

Table 20.2 Forms of Takeover Financing (2)

Available immediately:	Available in the medium or long term:
Existing credit lines. Free cash flow of the acquirer or the target. "The war chest". New credit lines and new syndicated loans. Securities lending.	Loan facilities. Syndicated loans. Convertible bonds. Public offerings. Release of capital (for example, through spin-offs, disinvestments, and asset securitisation).

Even from a legal perspective, different forms of acquisition financing can be divided into different categories in many ways. In the light of company law constraints, the main categories could be: financial assistance in advance; debt; shareholders' capital; mezzanine; and restructuring after the completion of the acquisition.

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[3] Schulte C, Corporate Finance. Die aktuellen Konzepte und Instrumente im Finanzmanagement. Vahlen, München (2006) p 248.

[4] *Ibid*, p 249.

20.2 Funding Mix

Europe has a substantially higher share of cash-financed takeovers compared with the US, and the share of purely equity-financed deals is much smaller in Europe than in the US.[5] The funding mix depends on many things.

Payment and financing. The questions of the method of payment and the source of financing are interrelated. Where the acquisition is paid for with cash, there must be a source of cash. Where the acquisition is paid for with a promise to pay cash in the future, some party must accept this promise. Where the acquisition is paid for with shares issued by the acquirer, the acquirer needs less cash to acquire the target, but there must be a party who subscribes for those shares.

Sources. Generally, the sources of acquisition finance exist at different levels of the investment chain: investors in the target; the target; the acquisition vehicle; investors in the acquisition vehicle; their investors; and so forth.

Depending on the case, each of those parties can find that its existing investment is being used to finance the acquisition, and each of those parties can provide new funds to finance the acquisition. Each party can invest shareholders' capital or act as a lender or mezzanine investor (debt mezzanine or equity mezzanine). Furthermore, each party can also benefit from assets that belong to particular asset investors (section 9.2), public goods provided by the state and other public bodies, as well as particular state or similar aids (Volume I).

The result can be a very complicated financing mix. What complicates the matter even more is the question of time.

Point in time. There is typically one financing mix for the acquisition at the time of closing and another financing mix after the acquirer has done two things: obtained control over the target; and restructured the financial structure of the whole firm, i.e. the financial structure of both the acquirer and the target. In a privately-negotiated transaction, the funding mix could consist of the following components at the time of closing and after restructuring:

Table 20.3 The Acquirer's Funding Mix for the Acquisition at the Time of Closing

Source: / Level:	*Existing assets*	*Shareholders*	*Lenders*	*Asset investors, public bodies*
Acquirer	Immediately available internal financing.	New equity investment.	New indebtedness, in particular acquisition bridge loans.	New assets, new subsidies and state aids.

[5] Hagendorff J, Collins M, Keasey K, Investor protection and the value effects of bank merger announcements in Europe and the US, J Banking Fin 32 (2008) pp 1333–1348.

Target	Share deal: financial assistance ex ante. Asset deal: cash payment in the future (loan).	Share deal: share exchange (equity investment). Share deal: cash payment in the future (loan, contingent claims). Other equity or debt investment.	Share deal: existing indebtedness. Asset deal: assignment of debts (novation).	New assets, new subsidies and state aids.

Legal aspects. From a legal perspective, the financing mix is influenced by the general legal aspects of different forms of funding (Chapter 2). Shareholders' capital is generally regarded as the most expensive form of funding, both in direct issuance-related and adverse-selection costs,[6] and the acquirer will take into account its desired level of gearing.

In addition to the general legal aspects of different forms of funding, the financing mix financing mix is also constrained by many particular restrictions such as:

- terms of existing indebtedness (in particular, material adverse change, change of control, financial covenants, and other covenants);
- terms of existing asset investment (similar covenants);
- terms of prior state aids and similar subsidies (in particular, terms the breach of which can trigger a duty to repay funds received by the target);[7]
- terms of existing equity and mezzanine investment;
- restrictions on financial assistance[8] and distributions[9] (in particular, restrictions applicable to the target);
- existing shareholders' pre-emption rights;[10]
- restrictions on the issuing of shares for a consideration other than in cash;[11] and
- the regulation of mergers[12] and divisions.[13]

In the context of acquisitions, the acquirer should also be aware of the risk that the acquisition will be regarded as a typical event that can trigger the exit of existing investors at any relevant level of the investment chain. For example, change of control may be regarded as an event of default under the target's existing loan

6 See, for example, Schlingemann FP, Financing decisions and bidder gains, J Corp Fin 10 (2004) pp 683–701.
7 See Wündisch S, In Subventionsbescheiden lauern oft versteckte Fallen, FAZ, 2 July 2008 p 23.
8 Article 24(1) of Directive 77/91/EEC (Second Company Law Directive).
9 Article 15 of Directive 77/91/EEC (Second Company Law Directive).
10 Article 29(1) of Directive 77/91/EEC (Second Company Law Directive).
11 Article 10 of Directive 77/91/EEC (Second Company Law Directive).
12 For example, Directive 78/855/EEC (Third Company Law Directive).
13 Directive 82/891/EEC (Sixth Company Law Directive).

agreements or as a termination event under the target's contracts with asset investors. Both cases can increase the acquirer's financing needs even more. In fact, many takeover defences work by increasing the financing needs of the acquirer (section 18.4). Sometimes the acquisition or the following refinancing and restructuring of the target can trigger an obligation to repay state subsidies or state aids, because state subsidies and state aids tend to be subject to conditions.[14]

It is therefore particularly important for the acquirer to find out about such things when it performs due diligence before agreeing to the terms of the acquisition (i.e. prior to signing).

Payment method and financing mix. The acquirer must seek a payment method which is attractive to the vendor or vendors and a financing mix which is attractive to investors – there will not be any deal without those two elements. On the other hand, both the payment method and the financing mix should, of course, be acceptable to the acquirer itself (for the pros and cons of different payment methods, see section 16.5).

Price and the financing mix. Even the price can influence the financing mix. For example, if the price is very low compared with the assets of the acquirer, the acquirer may be able to finance the acquisition internally, but a very high price will make external funding necessary:

"For each potential takeover price … the acquirer associates optimum acquisition and financing decisions … Thus, his financing opportunities may affect the takeover price offered … The takeover financing can be looked upon as a way in which the acquirer adapts to the price necessary for acquisition. In a bargaining process, as price rises the acquirer can modify the financing mix to best adapt to the price which must be paid to acquire the firm. However, financing can only be used to a limited extent, and there will exist a price for which no financing mix will increase the acquirer's utility above the existing level."[15]

Risk and the financing mix. The perceived risk-return profile of the acquisition can influence the financing mix. When the perceived risk is low, the acquirer may be prepared to raise more debt. When the perceived risk is high, the acquirer may prefer to raise more outside equity in order to reduce its overall corporate risk level, or search for co-owners in order share the risk.[16] The effect of risk can be illustrated by the acquisition of Sampo Bank by Danske Bank.

In November 2006, Danske Bank acquired all shares in Sampo Bank, a Finnish bank, for €4.050 billion (DKr30 billion) in cash from Sampo Group.

The Danske Bank Group changed its capital targets in connection with the purchase. The changes reflected the implementation of the new Capital Requirements Directive (Basel II, see section 3.5) and the increased geographical diversification which the Group achieved through its acquisition of Sampo Bank. The capital targets were changed to: a core

[14] See Wündisch S, *op cit*, p 23. For German law, see also § 3 Subventionsgesetz (SubvG) and § 264 Strafgesetzbuch (StGB).

[15] Grammatikos T, Makhija AK, Thompson HE, Financing Corporate Takeovers by Individuals Seeking Control, Managerial and Decision Economics 9(3) (1988) pp 227–235 at pp 233–234.

[16] *Ibid*, pp 234–235.

capital ratio, excluding hybrid capital, of 5.5%-6.0%;[17] a hybrid capital ratio of 1.0%-1.5%;[18] and a solvency ratio of 9%-10%.[19]

The financing mix therefore consisted of three main components: (a) equity issuance (DKr14.7 billion); (b) tier 1 hybrid issuance; and (c) securitisation of mortgages and corporate loans.

The share offering was decided on by the board of directors of Danske Bank pursuant to an authorisation contained in the bank's articles of association[20] and made to institutional investors in Denmark and internationally without the application of the pre-emption rights of existing shareholders.[21] The issuance of new equity was executed in November 2006 between the signing and closing of the acquisition agreement.

In December 2006 and February 2007, Danske Bank issued Hybrid Tier 1 Capital Notes as part of the financing of the acquisition of Sampo Bank. All Hybrid Tier 1 Capital Notes were perpetual and subordinated to all ordinary creditors and supplementary capital, senior only to the share capital. The Bank had the option to call the notes at their outstanding principal amount on certain dates. The amounts of the issues were £500 million, €600 million, and SEK 2 billion.

20.3 Particular Remarks on Securities Lending

Borrowing shares under a securities lending contract can enable the securities borrower to use voting rights during the term of the contract. This can make it easier for the acquirer to secure control at the general meeting. The acquirer can thus benefit from the assets of an "asset investor" (section 9.2) when applying a strategy called "record date capture".

Record date capture. Record date capture involves borrowing shares in the securities loan market just before the record date and returning the shares immediately afterwards. Under standard borrowing arrangements, the borrower has no economic exposure to the company. The borrower contracts with the share lender to (1) return the shares to the lender at any time at the election of either side, and (2) pay the lender an amount equal to any dividends or other distributions the borrower receives on the shares. This loan agreement leaves the borrower holding votes without economic ownership, while the lender has economic ownership without votes.[22]

As regards companies whose shares have been admitted to trading on a regulated market in the EU, record date capture was influenced by the shareholder

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[17] Core capital consists of issued and fully paid common stock and forms tier 1 capital. Paragraph 49(i) of the Basel II Accord.

[18] Hybrid debt capital instruments belong to tier 2 capital. Paragraph 49(xi) of the Basel II Accord. However, some innovative instruments belong to tier 1 capital. Basel Committee on Banking Supervision, Instruments eligible for inclusion in Tier 1 capital (27 October 1998).

[19] The main solvency ratio is 8%. See paragraph 40 of the Basel II Accord.

[20] Article 25(2) of Directive 77/91/EEC (Second Company Law Directive).

[21] Article 29(5) of Directive 77/91/EEC (Second Company Law Directive).

[22] Hu HTC, Black BS, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, U Penn L R 156 (2008) pp 625–739 at p 641.

rights Directive (2007/36/EC).[23] Directive 2007/36/EC requires a "record date". Member States must provide that "the rights of a shareholder to participate in a general meeting and to vote in respect of his shares shall be determined with respect to the shares held by that shareholder on a specified date prior to the general meeting (the record date)".[24] Depending on the governing law, the main rule is that a single record date applies to all companies and that at least eight days must elapse between the latest permissible date for the convocation of the general meeting and the record date.[25]

20.4 Financial Assistance

If, in a share deal, the acquirer must pay the purchase price at the time of closing (according to the "Zug-um-Zug" or "cash against delivery" principle), the acquirer will need a lot of money. The funding needs of the acquirer will be reduced if the acquirer can use the assets of the target company to pay for the shares. However, because of legal constraints, the target company may not freely give financial assistance with a view to the acquisition of its shares by a third party. The Second Directive lays down common rules on prohibited financial assistance for public limited-liability companies in the EU. On the other hand, all forms of financial assistance and functional equivalents to financial assistance are not prohibited.

The interpretation of financial assistance rules tends to be complicated. Usually, it is easier to understand them if one distinguishes between the following questions:

- The company. Whose actions are constrained by the rules? In other words, one should choose the perspective (the company).
- The target. To what shares do the rules apply? In other words, one should identify the companies whose shares are being acquired (for example, shares in the company itself, shares in the company's parent company or subsidiaries, shares in other companies).
- The acquirer. Whose acquisitions are covered by the rules? One should identify the acquirers covered by the restrictions (for example, a third party, a subsidiary of the third party, an agent of the third party, and so forth).
- The recipient. To whom must the company not give financial assistance under the rules? In other words, one should identify the parties to whom financial assistance may be given and the parties that must not receive financial assistance (for example, any party, the party who acquires the shares, an intermediary).
- Financial assistance. What kinds of actions are constrained by the rules? One should thus define restricted forms of financial assistance.

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[23] Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies.

[24] Article 7(2) of Directive 2007/36/EC.

[25] Article 7(3) of Directive 2007/36/EC.

In practice, it can be particularly difficult to define what financial assistance means and apply financial assistance rules to chain transactions.

Prohibited forms of financial assistance under the Second Directive. The Second Directive restricts the provision of various forms of financial assistance. Member States are permitted to adopt more stringent rules.

According to the wording of the Directive, the main rule is that a company may not advance funds, make loans, or provide security, with a view to the acquisition of its shares by a third party.[26]

It is clear that the restrictions will not apply unless the company is the target (see above).

However, two fundamental problems remain. Do the restrictions apply when the third party (the acquirer) is not the direct recipient of financial assistance? When does the company "advance funds", "make loans", or "provide security" (financial assistance).

The wording of the Directive is very broad. It could ban many leveraged buyouts just because the assets of the acquired company will be used as security in the economic sense.

The wording of the Second Directive covers: all forms of advancing funds, making loans, or providing security;[27] transactions before the takeover and after the takeover;[28] and even the merger of the acquisition vehicle and the target company after the completion of the takeover (for exceptions, see below).

Furthermore, the broad wording of the Directive covers circular transactions and chains of transactions where the target company subscribes for shares in, makes loans to, or advances funds otherwise to another legal entity for the purpose that the latter advances funds to a third party that will buy or subscribe for the target's shares (for chain transactions, see below).

Interestingly, the original rationale for the prohibition of financial assistance in England was the prevention of "asset-stripping" takeovers or leveraged buy-outs.[29]

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[26] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive).

[27] For English law, the starting point is Charterhouse Investment Trust v Tempest Diesels Ltd 1986 BCLC 1 in which Hoffmann J said: "There is no definition of giving financial assistance in the section [that preceded section 151 of the Companies Act 1985], although some examples are given. The words have no technical meaning and their frame of reference is … the language of ordinary commerce. One must examine the commercial realities of the transaction …"

[28] For German law, see § 71a AktG and § 30 GmbHG. See also Riegger B, Kapitalgesellschaftsrechtliche Grenzen der Finanzierung von Unternehmensübernahmen durch Finanzinvestoren, ZGR 2008 p 237; Weitnauer W, Die Acquisitionsfinanzierung auf dem Prüfstand der Kapitalerhaltungsregeln, ZIP 2005 p 791. For English law, see section 678(1) of the Companies Act 2008: "… before or at the same time as the acquisition takes place".

[29] See, for example, Armour J, Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law, Modern L R 63 (2000) p 368; Enriques L, Macey JR, Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules, Cornell L R 86 (2001) p 1181.

Financial assistance not prohibited under the Second Directive. Although the main rule is broad because of the open definition of financial assistance and the recipient of financial assistance, the prohibition of financial assistance has not hindered corporate takeovers in practice.

First, the Second Company Law Directive only applies to public limited-liability companies. Whether the prohibition applies to *private limited-liability companies* depends on the governing law.

In *England*, sections 155–158 of the Companies Act 1985 dealt with the "whitewash procedure" for private companies. Those provisions have been repealed. Private companies ceased to be subject to the financial assistance regime under the Companies Act 2006.[30] In *Germany*, the rules depend on the company form. The AktG prohibits financial assistance.[31] Where the company is a GmbH, the general prohibition of distribution of assets to shareholders applies. This means that the distributable assets of the company can be used to finance the acquisition.[32]

Second, the prohibition only applies to the purchase of shares. It does not restrict *asset deals*.

Third, the provisions of the Second Directive on financial assistance do not prohibit *permitted distributions* to shareholders regulated by other provisions of EU company law (see below).

Fourth, the Directive does not prevent *mergers*. Where shares of the target are bought by an acquisition vehicle that will be merged with the target after the successful completion of the takeover, the debts of the acquisition vehicle will be repaid from the assets of the target company.

In *Anglo Petroleum Ltd v TFB (Mortgages) Ltd*,[33] it was accepted that the use of money by a company to repay its existing indebtedness would not normally fall within the concept of the company giving financial assistance to another person.

Arguably, Article 23(1) of the Second Directive prohibits neither mergers where the target company is the surviving company (downstream merger, reverse takeover) nor mergers where the acquisition vehicle is the surviving company (upstream merger). This is because the Merger Directives permit both kinds of mergers. The provision on financial assistance should be construed and applied strictly so as not to frustrate the application of the rules applicable to mergers. On the other hand, downstream mergers may be constrained by Article 15(1) of the Second Directive which restricts the distribution of funds to shareholders.

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[30] For the scope of the restrictions, see sections 677–681 of the Companies Act 2006; Proctor C, Financial Assistance: New Proposals and New Perspectives, Comp Lawyer 28 (2007) pp 5–7. For the older rules, see also Cabrelli D, In Dire Need of Assistance? Sections 151–158 of the Companies Act 1985 revisited, JBL (2002) pp 272–291.

[31] See § 71a(2) AktG. See also § 57(1) AktG on the distribution of assets to shareholders.

[32] §§ 30 and 31 GmbHG.

[33] Anglo Petroleum Ltd v TFB (Mortgages) Ltd [2007] EWCA Civ 456.

In Germany, it has been argued that § 57(1) AktG can restrict a downstream merger between the takeover vehicle and the target company as illegal distribution of assets to the target company's shareholders.[34]

Fifth, the Directive does not prevent the target company from choosing a relatively *low subscription price* when issuing new shares to the acquirer in the context of a reverse takeover. The subscription price is constrained by: capital maintenance rules (section 5.4); pre-emptive rights and the need to obtain the consent of existing shareholders;[35] as well as the purpose of the company and other general legal constrains on the actions of board members.

Sixth, the *purpose* of the advancing of funds plays an important role. The wording of the Second Directive does not prohibit the company from advancing funds for a purpose other than the acquisition of its shares. It is therefore not sufficient for the financial assistance to be prohibited that it was given in the *context* of the acquisition; the company must have given the assistance for the purpose of the acquisition of its shares.[36]

The Directive is silent on the test to be applied. In principle, the test could be: subjective and focus on the intentions of the company; objective and focus on the transaction as a whole; or a combination of subjective and objective tests.

The relevance of the purpose of the advancing of funds can be illustrated by the case of Fiskars Corporation, a Finnish supplier of consumer goods. In 2004, Fiskars Corporation was a listed company controlled by the Ehrnrooth family through a number of holding companies. Investor, the investment vehicle of the Wallenberg family, owned a large block of shares in Fiskars through a holding company. Fiskars was the controlling shareholder of Wärtsilä Corporation, a much larger Finnish listed company. Through one of their holding companies, the Ehrnrooth family owned a large block of shares in Wärtsilä as well. In order to prevent Investor from selling its block of shares in Fiskars to outsiders, that Ehrnrooth holding company sold its shares in Wärtsilä Corporation to Fiskars Corporation and used the proceeds to buy the block of shares owned by Investor. Did Fiskars Corporation advance funds "with a view to the acquisition of its shares by a third party"?

From an economic perspective, this is certainly what seems to have happened. From a legal perspective, the answer depends on the test to be applied. In order to mitigate the risk of non-compliance, Fiskars Corporation said that it purchased Wärtsilä shares as part of its long-term investment strategy of remaining the biggest shareholder of Wärtsilä. In other words, Fiskars said that those payments were not made for the *purpose* of financing the

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34 See Riegger B, Kapitalgesellschaftsrechtliche Grenzen der Finanzierung von Unternehmensübernahmen durch Finanzinvestoren, ZGR 2008 pp 246–247.

35 Article 29 of Directive 77/91/EEC (Second Company Law Directive).

36 For older English law, see Charterhouse Investment Trust Ltd v Tempest Diesels Ltd 1986 BCLC 1 ("for the purpose of or in connection with") as well as sections 153(1) (the "pre-acquisition exception") and 153(2) (the "post-acquisition exception") of the Companies Act 1985. For present law, see section 679(1) of the Companies Act 2006 ("directly or indirectly for the purpose of the acquisition before or at the same time as the acquisition takes place"). For the distinction between "for the purpose of" and "in connection with", see, for example, Senior G, Takeovers of Companies in the United Kingdom, Australia, Canada, and Hong Kong: Prohibited Financial Assistance – A Trap for the Unwary, The International Lawyer 25(3) (1991) pp 587–613.

purchase of Fiskars shares by any party.[37] An objective test might have lead to another conclusion.

As the purpose of the prohibition of financial assistance is to protect (other) shareholders and third parties such as the company's creditors,[38] the test should be an *objective* one. This does not prevent the use of an additional subjective test.

In the English case of *Brady v Brady*,[39] Lord Oliver distinguished between the principal purpose and subsidiary purposes. The case leaves plenty of room for interpretation.[40] The test contains both objective and subjective elements under the Companies Act 2006.[41] The "principal purpose" test implies the test can be an objective one. The "good faith" test implies that the objective test is complemented by a subjective test. In *Anglo Petroleum Ltd v TFB (Mortgages) Ltd*,[42] it was accepted that the use of money by a company to repay its existing indebtedness would not normally fall within the concept of the company giving financial assistance to another person.

Seventh, the Second Directive was amended in 2006 and now provides for *exceptions* from the main rule. New provisions of Member States' laws implementing Directive 2006/68/EC have made it easier to provide financial assistance.

The purpose of the amendments was to enable Member States "to permit public limited liability companies to grant financial assistance with a view to the acquisition of their shares by a third party up to the limit of the company's distributable reserves so as to increase flexibility with regard to changes in the ownership structure of the share capital of companies". According to the purpose of the Directive, this possibility should be subject to safeguards, having regard to the objective of protecting both shareholders and third parties. [43] In practice, it can be legally too time-consuming for the company to comply with the conditions set out in the Second Directive. The most important rules are as follows:[44]

- Member States have a right but not a duty to permit a company to, either directly or indirectly, advance funds or make loans or provide security, with a view to the acquisition of its shares by a third party.
- If they do, the conditions set out in Article 23(1) of the Second Company Law Directive (as amended) must be complied with.
- The transactions must take place under the responsibility of the administrative or management body at fair market conditions. Fair market conditions mean

[37] Fiskars Corporation, stock exchange releases dated 1 April 2004.
[38] Recital 2 of Directive 77/91/EEC (Second Company Law Directive).
[39] Brady v Brady [1989] AC 755.
[40] Ferran E, *op cit*, pp 293–297; see also Cabrelli D, In Dire Need of Assistance? Sections 151–158 of the Companies Act 1985 revisited, JBL (2002) pp 281–283.
[41] Sections 678 and 679 of the Companies Act 2006.
[42] Anglo Petroleum Ltd v TFB (Mortgages) Ltd [2007] EWCA Civ 456.
[43] Recital 5 of Directive 2006/68/EC.
[44] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive) as amended by Article 1(6) of Directive 2006/68/EC.

that the company must take into account the credit standing of the third party, interest rate, and security provided to the company.

- The general meeting will have a veto right. The transactions must be submitted by the administrative or management body to the general meeting for prior approval. The administrative or management body must present a written report to the general meeting. In addition, there are special requirements as to quorum and majority.[45]
- There is a maximum limit for the aggregate financial assistance. The aggregate financial assistance granted to third parties shall at no time result in the reduction of the net assets below the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes. The acquisition by the company of its own shares will reduce net assets.
- Where a third party by means of financial assistance from a company acquires that company's own shares or subscribes for shares issued in the course of an increase in the subscribed capital, such acquisition or subscription shall be made at a fair price.

It is thus voluntary for Member States to adopt the exceptions. Neither Germany nor the UK have adopted them.

In *Germany*, the MoMiG relaxed the rules on the distribution of assets for both company forms in 2008. However, the AktG has not yet made use of the new right of Member States to permit financial assistance on certain conditions.[46] The MoMiG made it easier for group companies to grant collateral.[47] In *England*, the Companies Act 2006 provides for "unconditional exceptions". However, the exceptions cover permitted forms of distributions (see below).[48]

Eighth, there is a narrow exception that applies to normal transactions concluded by banks and to employee share ownership.[49]

Circular and chain transactions. Circular and chain transactions can cause particular problems of interpretation.[50] For example, should the same prohibitions apply to the purchase of shares in the company's parent company by a third party? Should the recipient of funds be the party that acquires the shares?

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[45] Article 40 of Directive 77/91/EEC (Second Company Law Directive).

[46] See, for example, Habersack M, Kapitalerhaltung. Brüssel rüttelt an Finanzverfassung der Unternehmen, FAZ, 21 November 2007 p 25.

[47] Wiehe H, Jordans R, Cash Pooling and Granting Up-stream Security in Acquisition Finance under German Law-Current Situation and Intended Changes, JIBLR 23(7) (2008) pp 351–353.

[48] Section 681 of the Companies Act 2006.

[49] Article 23(2) of Directive 77/91/EEC (Second Company Law Directive).

[50] For circular transactions under Swedish law, see Skog R, Ömsesidigt aktieägande och aktiebolagslagens regler om förvärv och innehav av egna aktier. SOU 1998:38, Ägande och inflytande i svenskt näringsliv. En expertrapport från ägarutredningen. Industridepartementet. Bilaga 1.

According to the wording of the Second Directive, the main restrictions apply only where the company that provides the assistance (advances funds, makes loans, or provides security) is the target company (the company whose shares are acquired).[51]

According to the wording of the Directive, the main restrictions can apply whether or not the third party that receives the funds, loans, or security directly from the company is the party that acquires the company's shares. Restrictions can thus apply to chain transactions. Article 23a can influence the interpretation of the scope of the main restrictions.

In some cases,[52] Member States must "ensure through adequate safeguards" that the transaction "does not conflict with the company's best interests". This is the case where one of the parties to a transaction referred to in Article 23(1) (acquisition of the company's shares, funding, loan, security)[53] is a person referred to in Article 23a (member of the company's administrative or management body; the company's parent undertaking; member of the parent undertaking's administrative or management body; or an individual acting in his own name, but on behalf of such a party).

This means that the main restrictions can cover at least the following types of transactions:

- The company provides funding, a loan, or a security directly to the third party that acquires shares of the company.
- The company provides funding, a loan, or a security directly to one party in a transaction that enables a third party to acquire shares of the company (chain transaction).
- In such a chain transaction, the scope of the main restrictions is limited in particular by the *purpose* of the company's acts.[54]
- In any case, where the purpose of the company's acts is to provide financial assistance for the purpose of the acquisition of its shares by a third party, the main restrictions can cover: (a) acquisitions of the company's shares where the buyer is a party referred to in Article 23a; (b) acquisitions of the company's shares where the party receiving assistance directly from the company is a party referred to in Article 23a; and (c) acquisitions of the company's shares where either the buyer or the party receiving assistance directly from the company is an individual acting in his own name, but on behalf of a party referred to in Article 23a.[55]

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[51] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive).

[52] Article 23a of Directive 77/91/EEC (Second Company Law Directive) inserted by Directive 2006/68/EC.

[53] Article 23a refers to "a transaction referred to in Article 23(1)". Article 23(1) refers to the acquisition of the company's shares and restricted forms of financial assistance.

[54] Article 23(1): "… with a view to the acquisition of its shares by a third party …"

[55] The use of intermediaries is restricted even by Articles 18(2) and 19(1) of Directive 77/91/EEC (Second Company Law Directive).

Furthermore, the transaction must not "conflict with the company's best interests", where at least one of the parties to a transaction referred in Article 23(1) is a party referred to in Article 23a (see above).

The wording of the Second Directive does not prohibit circular transactions or chains of transactions where the company has advanced funds for a purpose other than the acquisition of its shares (see above).

Neither does the wording of the Directive prohibit a company from providing financial assistance to a third party for the purpose of buying shares in the company's parent or subsidiary company or a third company. Such transactions can nevertheless be constrained by the governing law.

In *England*, the Companies Act 2006 restricts the giving of financial assistance by a subsidiary for the acquisition of shares in its parent company. The prohibition applies even where the parent company is a private holding company.[56] In *Germany*, however, the giving of financial assistance for the acquisition of shares in a third company is governed by provisions that act as a constraint on corporate actions generally. It is not covered by the prohibition of financial assistance.[57]

Distributions to shareholders as financial assistance ex post and ex ante. The Second Directive does not prevent distributions that have explicitly been permitted by provisions of EU company law.[58] This is because of the general principle that the provisions of a directive cannot be interpreted in such a way that they would frustrate the effectiveness of other provisions of the same directive or the provisions of another directive.

After the completion of the acquisition, the target company can therefore distribute funds to shareholders in the form of dividends, through share buy-backs, through withdrawal of shares, or otherwise as permitted by provisions of EU company law (section 10.2).

Whether the target company is permitted to do the same before the acquisition and advance funds "with a view to the acquisition of its shares by a third party" by such means is a matter of interpretation. Again, no provision of the Second Directive can prohibit the distribution of profits where the conditions expressly set out in the Second Directive for profit distributions have been met. On the other hand, the wording of the Directive clearly prohibits the granting of loans to any party for the purpose of acquiring shares in the company regardless of whether that party is a non-shareholder or a shareholder and regardless of whether the making of loans to shareholders is governed by particular company law rules.[59]

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56 Section 679 of the Companies Act 2006.

57 For German law, see § 71a AktG.

58 See also section 681 of the Companies Act 2006.

59 See nevertheless Habersack M, Kapitalerhaltung. Brüssel rüttelt an Finanzverfassung der Unternehmen, FAZ, 21 November 2007, p 25: "Vor diesem Hintergrund ist mit einer Änderung von Paragraph 71a AktG nicht zu rechnen. Allerdings wird der deutsche Gesetzgeber auch zu bedenken haben, dass das MoMiG aller Voraussicht nach zu einer Lockerung der in Paragraph 57 AktG geregelten strikten Vermögensbindung führen wird: Die Vergabe von Darlehen an Aktionäre und die Stellung von Sicherheiten zugun-

20.5 Debt

20.5.1 General Remarks

Leveraged buyouts bring many benefits to the acquirer. A high leverage ex ante can increase return enormously, if the debts will be bourne by the target ex post after the completion of the acquisition. The acquirer can decide on debt funding without turning to shareholders, and it will not change the ownership structure of the company (for the benefits of debt, see section 4.1). There are also other benefits (see section 10.5 on refinancing).

Acquirers typically increase leverage to increase risk and return when the perceived risk is low. For example, few US companies relied on debt as a significant source of acquisition funding after the Second World War, because the Great Depression was still a very recent memory, and the perceived risk inherent in high leverage was still high.

Following a wave of conglomerate building, many listed companies were trading at a discount to net asset value. New firms saw an opportunity to profit from inefficient and undervalued corporate assets. In the late 1970s and early 1980s, many leveraged buyouts were motivated by profits available from buying entire companies, breaking them up and selling off the pieces.

Higher leverage as a trend. One of the main trends in the market for leveraged acquisition finance has involved the creation of new practices and instruments by which the overall size of debt can be increased. This increased the price of companies before the financial crisis that began in 2007, and will contribute to higher prices after the crisis.

First, many acquirers want to ensure that responsibility for the repayment of the debt is bourne by the target. The lower risk exposure of acquirers has given an incentive to increase the size of debt raised from banks and reduce the amount of equity invested by the acquirers themselves. The heavy indebtedness of the target company is associated with increased risks.

Second, banks have learnt to sell the debt or credit risk to other financial institutions. Where banks do not keep the original credit exposure in their books, debt sizes can be expected to rise.

Third, the entry of new types of debt investors (such as hedge funds, insurance companies, mutual funds) and new kinds of debt instruments (CDOs and CLOs) has increased the availability of debt funding for leveraged acquisition transactions.

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sten von Aktionären sollen künftig nur noch davon abhängig sein, dass die Gesellschaft über einen vollwertigen Rückzahlungs- oder Rückgriffsanspruch verfügt. Bliebe nun Paragraph 71a AktG unverändert, so erlangte das Verbot der finanziellen Unterstützung - anders als bislang - einen eigenständigen Charakter. Denn es würde gezielt die Mitwirkung der Zielgesellschaft an einer fremdfinanzierten Übernahme (Leveraged Buyout) verbieten, obschon entsprechende Unterstützungen finanzieller Art zugunsten „gewöhnlicher“ Aktionäre künftig durchaus erlaubt wären.”

These new debt investors are looking for a higher margin for a longer term than that sought by traditional bank debt providers in the market.[60]

Fourth, the availability of more debt and the chances of acquirers to separate control and risk have driven prices higher. (During the financial crisis which began in 2007, access to debt was reduced. This reduced the leverage of LBOs.)

Fifth, the emergence of private equity funds has had a similar effect for various reasons. Private equity funds have increased demand for companies. The structure of private equity funds (section 5.6.4) and the fee structure of fund managers (see also Volume II) have given fund managers an incentive to pay higher prices for companies. Furthermore, private equity funds will exit the target company after a few years. This has made it easier for them to load the target company with debt.

Sources of debt. While small acquisitions tend to be financed locally, large leveraged buy-outs are financed from international capital markets.[61] In a large acquisition, the debt package typically consists of different types of loan facilities. (a) Traditional banks provide senior debt. In larger acquisitions, it is not uncommon for the debt finance to be by way of syndicated loan.[62] (b) New types of investors typically provide bullet facilities with longer maturities for higher margins. The debt holder has typically an option to reject early prepayment if the senior loan facility remains outstanding. (c) The margins are expected to be higher in mezzanine loan facilities and high-yield (junk) bond issues. As a result, there is demand for such instruments from various kinds of funds provided that the instruments are sufficiently liquid. Mezzanine loan instruments are always subordinated pursuant to the intercreditor agreement and in many cases even structurally subordinated. As some of the investment parameters of some funds require them to invest only in senior debt, the subordination of collateral and second lien instruments are sometimes used instead of the subordination of debt (sections 6.3.5 and 6.3.6). (d) Less frequently, payment-in-kind (PIK) notes may be issued (see below and Volume II).[63]

Structure of an LBO. This can lead to a complicated LBO structure in a share deal.

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[60] Sharples R, United Kingdom: How Europe is stretching debt packages, The IFLR guide to Mergers and Acquisitions 2005.

[61] See Diem A, *op cit*, § 6 numbers 1–6.

[62] See Gayle C, Acquisition Finance – Syndication Best Practice, Int Comp Comm L R 13(8) (2002) p 300.

[63] See, for example, Sharples R, *op cit*.

Table 20.5 LBO Structure (Deutsche Bundesbank 2007)[64]

Acquisition	Funding (with an increasing seniority of debt)
Financial investors: capital investment in parent company.	
Parent company: passes on funds to sub-holding company.	← Target shareholders can grant a loan.
Sub-holding company: passes on funds to acquisition vehicle.	← Target shareholders can grant payment time. ← Mezzanine creditors can provide loans.
Acquisition vehicle: acquires the target company.	← Second lien creditors can provide loans. ← Senior lenders can provide term loans.
Target company: makes distributions to shareholders.	

Senior loans are granted to the acquisition vehicle in order to reduce structural subordination and to make it easier to gain access to the target's cash flows and collateral. Within the category of senior loans, the most senior tranche (say, A) is usually repaid on a regular basis according to a repayment schedule. Other senior tranches can be bullet loans repaid at maturity. Second lien loans entitle their holders only to subordinated claims to collateral. Mezzanine loans provided to the sub-holding company will be structurally subordinated. The following is an example of how the debt mix of a major LBO might look.

Table 20.6 Debt Mix of an LBO (Deutsche Bundesbank 2007)[65]

Tranche	%	Spread (basis points)	Maturity
Term loan A Term loan B Term loan C	11 11 31	200 250 300	7 years, repayments 8 years, bullet 9 years, bullet
Senior debt Second lien	73 11	(see above) 475	(see above) 9.5 years, bullet
Senior and second lien Mezzanine	84 16	(see above) 9% cash/PIK	(see above) 10 years, bullet
Total debt	100	(see above)	(see above)

Particular legal aspects. Typically, at least four things give rise to particular legal concerns in addition to the general legal characteristics of acquisition finance and debt finance (see above):

- Generally, the acquirer should ensure that the legal framework of the acquisition and the legal framework of the loan facility are mutually coherent.

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64 Compare Deutsche Bundesbank, Leveraged buyouts: the role of financial intermediaries and aspects of financial stability. In: Monthly Report, April 2007 p 16.
65 *Ibid*, p 17.

- The acquirer should ensure that it does not promise to buy the target before it is certain that banks will provide the necessary funding.
- The acquirer should try to limit the cumulation of legal risk caused by the existence of two contractual relationships: vendor v buyer and buyer v the banks. In particular, the acquirer should try to ensure that breach of the terms of the acquisition agreement by the vendor will not trigger an event of default by the debtor under the loan facility agreement. The cumulation of legal risk increases if the specifications of the target (warranties) belong to the representations, warranties and covenants of both the vendor (under the acquisition agreement) and the debtor (under the loan facility agreement).
- Furthermore, the acquirer should ensure that the legal frameworks for both transactions enable it to refinance the transaction after the acquirer has completed the acquisition.

The contract process in a leveraged buy-out. The contract process depends on the perspective (the perspective of the acquirer/borrower v the perspective of the lenders). In any case, the acquirer will need to understand the process from the lenders' perspective in order to align the funding process with the acquisition process.

For example, evidence of "certain funds" is often required in auctions in which the vendor can require the potential bidders to submit documentation showing that the lenders have promised to provide funding.[66] Furthermore, the acquirer will need funds at the time of closing of the acquisition agreement, but, under the terms of the loan facility agreement, the facility may not be drawn unless all security and collateral arrangements are already in place.

20.5.2 Commitment of Banks

There is a conflict between the legal interests of the acquirer, the lenders, and the vendor. The acquirer should not promise to buy the target unless the lenders have promised to provide the necessary funding.

On the other hand, the lenders cannot promise to provide the necessary funding unless they have been able to perform the customary credit checks and due diligence inspections and determine the creditworthiness of the borrower. For example, the lenders must analyse both the proposed acquisition and the proposed credit facility, and the due diligence inspections should cover not only the prospective borrower but also the target company and other relevant companies.

Furthermore, the lenders will not promise funding unless they understand the acquirer's restructuring and refinancing plans for the target. Unfortunately, the lenders might not have free access to the target company, the terms of the acquisition agreement might not yet be clear, and the restructuring and refinancing plans might still be open.

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[66] Diem A, *op cit*, § 2 number 22.

For such reasons, the lenders might not be willing to give any binding promise to provide the necessary funding.

This could lead to problems with the vendor. In practice, the vendor's legal advisers will carefully inspect the debt funding term sheets of the potential acquirer for clauses that enable the lenders – and therefore even the acquirer – to walk away. In many cases, the vendor will not continue talks with a potential acquirer unless the latter can show that it has the required financial means to fulfil its proposed obligations. This is particularly the case in auctions.[67]

There are two main ways to address this problem at least partly: (1) through a combination of conditions precedent to closing under the acquisition agreement and commitment letters before the drafting of the loan facility agreement; and (2) through "certain funds" rules that are mandatory as a legal requirement or de facto mandatory as market practice.

Commitment letter. The legal meaning of a commitment letter depends on how it will interpreted, and interpretation depends on the exact wording of the commitment letter and the circumstances. In any case, the banks will not want to make any binding promise enforceable by the court to lend money before the terms of the acquisition and the refinancing and restructuring plans for the target are clear.

On first sight, the commitment letter contains an undertaking to provide funding. (a) In large transactions, the commitment letter can lay down an obligation to underwrite the loan. In that case, the underwriter bears the risk that it cannot sell the loan to other investors or that syndication will fail. (b) Some commitment letters might only lay down an obligation to arrange a loan facility. If the arranger has not undertaken any obligation to underwite the loan itself, the arranger only has a duty to use its best efforts to arrange a consortium that will underwrite the loan.[68]

The lender typically tries to mitigate risk by using extensive conditions. (a) For this purpose, the commitment letter can contain a description of all financing transactions in the context of the acquisition. It can be explicitly stated that there will not be any other indebtedness than indebtedness mentioned in the commitment letter. (b) The commitment letter can be made subject to the fulfilment by the borrower of all its obligations under the commitment letter, in particular the prompt payment of all fees, and the fulfilment by the borrower of all terms under the proposed loan facility agreement or the term sheet that contains its core terms. (c) The commitment letter is usually made subject to the absence of a material adverse change. (d) In addition, it can, in many ways, be subject to contract.[69] How this is done depends on the case, and different commitment letters can have various terms of enforceability. A commitment letter "subject to contract" will not be regarded as an enforceable promise to provide funding. The same can be said of a commitment letter "subject to documentation satisfactory to the bank", although the bank may have a duty not to withhold its acceptance unreasonably under the mandatory provisions of the governing law (Volume II). The phrase "subject to

[67] *Ibid*, § 2 number 22.
[68] *Ibid*, § 2 number 25.
[69] *Ibid*, § 2 number 24.

documentation" increases the probability that the commintment letter leads to an enforceable promise to provide funding, if the parties have agreed on the core commercial terms of the loan facility (in the term sheet annexed to the commitment letter or otherwise) and the court will be able to decide what the others terms should be.[70] How a commitment letter works can be illustrated by the following example.

A certain borrower may need to raise the following funding in the context of an acquisition: a short-term bridge loan facility; a long-term loan facility following refinancing after the completion of the acquisition; and excess cash. In such a case, the commitment letter could first: describe the various loan facilities; contain a statement that no other financing will be required for the uses described in the commitment letter; and contain a statement that the borrower will have no other indebtedness or preferred equity. Subsequently, the commitment letter would contain a bank's promise.

The promise to provide a bridge loan could look as follows: "The Bank is pleased to advise you of its commitment to provide the entire amount of the Bridge Facility to Borrower upon the terms and subject to the conditions set forth or referred to in this Commitment Letter."

The commitment letter would contain core information about the Bridge Facility. The Bridge Facility Term Sheet would set forth its terms and conditions.

The commitment letter would nevertheless be diluted in many ways. First, the commitment of the bank would be subject to contract: "The commitment of the Bank hereunder is subject to the negotiation, execution and delivery of definitive documentation with respect to the Bridge Facility reasonably satisfactory to the Bank reflecting the terms and conditions set forth in the Bridge Term Sheet, the Conditions Annex and the Fee Letter, and such other terms (but not conditions) as you and we may mutually agree." Second, the commitment would be diluted by conditions. For example, the bank could reserve the right to terminate its commitment if: (a) a material adverse change has occurred; or (b) any condition set forth in either Term Sheet or the Conditions Annex is not satisfied or any covenant or agreement in the Commitment Letter or the Fee Letter is not complied with in any material respect. Third, the borrower would be made to undertake a duty to pay a fee under a Fee Letter.

"Certain funds". Sometimes a relatively high degree of enforceability is necessary for legal reasons. In order to protect market participants and the target, the City Code on Takeovers and Mergers (the City Code or the Takeover Code) requires the existence of "certain funds" before the making of a bid. The "certain funds" requirement is a legal implant used even in other contexts and in other Member States. Competition has driven the mandatory City Code "certain funds" requirement to be adopted as market practice in private equity transactions and in many public takeover bids. It is often used in auctions, and it has also influenced many other privately-negotiated acquisitions.

According to the general principles of the Code, an offeror "must announce a bid only after ensuring that he/she can fulfil in full any cash consideration if such is offered, and after taking all reasonable measures to secure the implementation of any other type of considera-

[70] See Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) pp 301–303.

tion" (General Principle 5). Under the rules of the City Code, an offeror should make an announcement of a firm intention to make an offer only when the offeror "has every reason to believe that it can and will continue to be able to implement the offer" (Rule 2.5). Pre-conditions to the offer are not permitted under the rules of the City Code, if they "depend solely on subjective judgements by the directors of the offeror or of the offeree company (as the case may be) or the fulfilment of which is in their hands" (Rule 13.1).

This means that: certain funds must be available to implement the bid; and the offer must not, under normal conditions, be made subject to any financing conditions or pre-conditions other than regulatory clearances.

Interestingly, the market for corporate control is more flexible and lender-friendly for companies listed in the US. There are no restrictions on the conditionality of the bid and no certain funds requirements.[71]

In market practice, any potential offeror or buyer wanting to be taken seriously must demonstrate reasonable certainty of funding. This has made it increasingly difficult for lenders to negotiate conditions not included in the acquisition offer. A pre-condition requiring the absence of any material adverse change is fairly standard.

Conditions precedent. As said above (section 12.5), the availability of funding is a typical condition precedent to closing in a privately negotiated acquisition.[72] Even the loan facility agreement contains conditions precedent. In addition to conditions precedent to closing, the agreement lays down conditions precedent to drawdown (see below).

20.5.3 Many Legal Entities on the Side of the Borrower

General Remarks

The existence of two or more legal entities on the side of the borrower and the changing of control over the target following a completed acquisition will influence the legal framework. The acquirer will try to ensure that it can complete the acquisition, restructure the target, refinance the acquisition, have managerial discretion to run the business, and exit the target in due course. The lenders will try to ensure that they can understand the nature of the participating companies and the transactions, manage their risk exposure, and avoid any material adverse change in their risk exposure. For this reason, they must review not only the proposed loan facility but also the proposed acquisition and the planned restructuring and refinancing. The lenders must also perform a due diligence inspection of all relevant companies on the side of the borrower and a due diligence inspection of the target.

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[71] Bids for US-listed companies are regulated by the Williams Act 1968, which grants the SEC authority to establish rules to govern bids for shares in companies registered under the Securities Exchange Act 1934.

[72] See nevertheless Rule 13.1 of the City Code on Takeovers and Mergers.

Credit Enhancements Under the Acquisition Loan Facility Agreement

Because of the highly leveraged nature of acquisition financing, lenders might require a comprehensive collateral and guarantee package from the borrowers and the target, as well as any material subsidiaries. Credit enhancements can increase the availability of acquisition financing and reduce its cost.

As said above, it is characteristic of acquisition financing that the acquired business is expected to pay for itself. The cash flows generated by the acquired business will be used to service the debt raised by the acquirer.

Whether the target can provide collateral and guarantees in advance is nevertheless constrained by financial assistance rules. For example, the Second Company Law Directive provides that a company may not provide security with a view to the acquisition of its shares by a third party.[73]

In addition, provisions of the applicable company law may restrict a subsidiary's right to give a guarantee or provide collateral for the security of its parent's obligations. Such transactions do not always fall within the capacity of the subsidiary company, and they are not always compatible with its stated objects. Furthermore, there can be explicit provisions of company law restricting such transactions (for counterparty corporate risk, see Volume II).

However, common credit enhancements can be used even in the context of acquisition loan facility agreements.

It is characteristic of acquisition financing that there is a conflict of interest between the ultimate owners of the acquisition vehicle/target on one hand and the lenders on the other. While the lenders provide the largest part of takeover financing, the ultimate owners of the acquisition vehicle/target enjoy the benefits of controlling it under the protection of shareholders' limited liability. Lenders will therefore take steps to align the interests of the ultimate owners with those of their own. For example, the lenders can require them to provide a larger equity component and subordinated debt.

Structural Subordination

A leveraged buy-out can lead to structural subordination (section 6.3.2). Where funds are borrowed by the acquirer (often a holding company or acquisition vehicle), creditors of the acquirer rank behind creditors of the target (the operating company).[74] Where the acquirer is an acquisition vehicle with no other assets of its own, the risk exposure of lenders can be increased by lack of collateral. In principle, the acquisition vehicle could grant a security interests in the target's shares. However, even such a security would be structurally subordinated and of little value in the bankruptcy of the target.[75] There are several common ways to reduce structural subordination in the context of acquisitions.

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[73] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive).
[74] See Diem A, *op cit*, § 6 number 9.
[75] See *ibid*, § 6 number 8.

Restructuring of the target's debt. One solution is to mitigate the effects of the structural subordination by aligning the interests of the target's and the acquirer's lenders. Typically, the target's existing indebtedness will be repaid and replaced by new loans granted by the acquirer's lenders.[76]

Undertakings by the target. In principle, debt push-down could provide an alternative. A possible solution could be: to transfer the acquirer's debts to the target by means of novation; or to ask the target to provide security for the acquirer's indebtedness by means of acceptance of co-responsibility for their repayment or the giving of guarantees or collateral.[77]

However, debt push-down and the giving of guarantees or collateral can be legally problematic because of timing issues, constraints on financial assistance (see above), and general company law constraints on the use of the target's assets.

The target cannot execute any debt push-down *before closing* because of: legal restrictions on financial assistance;[78] company law rules prohibiting transactions that are not in the interests of the company; company law rules protecting other shareholders and creditors; company law rules on the duties of the target's representatives; and company law restrictions on the representatives' power to bind the company (for counterparty corporate risk, see Volume II).[79]

The same constraints apply *at closing* and *after closing*.[80] It is a matter of interpretation whether the target company can circumvent the prohibition on financial assistance by concluding, before the closing of the acquisition agreement, an agreement on debt push-down on such terms that the contract will become binding after the target has taken all necessary corporate action to authorise it following the closing of the acquisition agreement. However, the wording of the Second Company Law Directive is broad enough to prohibit even such transactions.[81]

Restrictions on the distribution of assets after closing. After the acquirer and the vendor have closed the acquisition agreement and the acquirer has become shareholder of the target, the making of payments to the acquirer will be constrained by general restrictions on the distribution of assets to shareholders (section 10.2).

Example: AG. For example, a German AG would not be able to grant security for the repayment of the short-term bridge loans of the acquirer.[82] Such a transaction would be contrary to rules on the distribution of assets to shareholders in general (Einlagenrückgewähr)[83] and, if the debts are based on an acquisition loan facility, contrary to rules on financial as-

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[76] *Ibid*, § 6 number 10.
[77] *Ibid*, § 6 number 10.
[78] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive).
[79] Diem A, *op cit*, § 6 number 11.
[80] *Ibid*, § 6 number 11.
[81] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive).
[82] Diem A, *op cit*, § 3 number 3. See also § 46 number 1.
[83] § 57 AktG.

sistance.[84] In addition, the management board would breach its general duty of care and become liable for any damage sustained by the company thereby.[85]

On the other hand, the target company and the acquirer, as its new parent, could conclude a control agreement (Beherrschungs- und Gewinnabführungsvertrag) to mitigate the effect of such constraints.[86]

As the rules applicable to GmbHs are more flexible than those applicable to AGs, one of the alternatives could be the conversion (Umwandlung) of the AG into a GmbH or a GmbH & Co. KG.[87]

Example: GmbH. In this case, the transaction would be constrained by legal capital rules and restrictions that apply to transactions that can endanger the existence of the company (Existenzvernichtung).[88]

Under German legal capital rules, a GmbH must have a stated amount of capital (Stammkapital) that resembles share capital. A GmbH may not distribute assets to shareholders to the extent that the assets are necessary for the maintenance of the stated capital.[89] Whereas the granting of security or the provision of collateral will not yet reduce the company's assets, actual payments will.[90]

Where such a transaction for the benefit of the parent company puts the existence of the GmbH at risk, the parent company may become liable to the GmbH's creditors according to the doctrine of lifting the veil (Durchgriff), and the board members of the participating companies may become personally liable.[91]

Undertakings by the acquirer. On the other hand, while the target company must comply with company law restrictions which apply to its own actions, companies on the side of the acquirer can – in their dealings with the lenders – agree on their own obligations.

For example, companies on the side of the acquirer can agree on a bridge loan facility and all loan facilities that will become necessary in the context of refinancing and the restructuring of the target after the completion of the acquisition. They can even guarantee that the target will accept its refinancing and restructuring obligations during a certain period of time after the closing of the acquisition agreement. Whether they fulfil their contractual obligations to the lenders will then partly depend on the contents of company law constraints that apply to the actions of the target.

Typically, companies on the side of the acquirer agree with lenders on restructuring through the merger of the acquisition vehicle and the target company. In this case, the existence of minority shareholders would increase legal risk, as minority shareholders can have the power to block the merger and/or appraisal rights (section 10.4.2).

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[84] § 71a AktG.
[85] § 93 AktG.
[86] Diem A, *op cit*, § 6 number 14.
[87] *Ibid*, § 6 number 14.
[88] *Ibid*, § 3 number 3. See also § 44 numbers 1 and 85.
[89] § 30(1) GmbHG: "Das zur Erhaltung des Stammkapitals erforderliche Vermögen der Gesellschaft darf an die Gesellschafter nicht ausgezahlt werden."
[90] Diem A, *op cit*, § 6 number 12. See also § 44 number 2.
[91] *Ibid*, § 6 number 13. See also § 44 number 85.

Restructuring and Refinancing After Change of Control

After the acquirer has obtained control over the target company following the closing of the acquisition agreement, the target and its existing debt will often be restructured.[92] This is why "advance restructuring" can also be used as a defence against hostile takeover bids, corporate predators and private-equity firms (section 18.2).

The purpose of restructuring and refinancing is to: (a) put in place a funding mix according to the acquirer's own funding objectives; (b) use the assets of the target to repay acquisition loans; (c) avoid structural subordination and obtain better credit terms; (d) replace short-term loans with long-term loans; (e) increase liquidity; (f) release capital; and (g) increase cash-flow. There can also be tax reasons for restructuring.[93]

For example, where an asset-light acquirer has too much debt following the acquisition, the acquirer and the target can merge. The merger will also help the acquirer to mitigate problems caused by restrictions on the distribution of assets[94] and by structural subordination.[95] The merger will enable a debt push-down.

In a German target-AG, this would usually require a majority of 75% at the general meeting,[96] but the decision to merge would virtually always be contested in the court by minority shareholders[97] unless minority shareholders have already been squeezed out.[98] Before a merger, minority shareholders of the target have an incentive to force the two companies to agree on control (Beherrschungs- und Gewinnabführungsvertrag) as this would guarantee them dividend payments (Garantiedividende).[99]

Where the company still has too much debt, it can sell assets to repay part of the debt and renegotiate its terms.[100] The sale of assets is often called "the sale of assets that do not belong to the company's core business", "the sale of unperforming assets", or "asset-stripping". The sale of unperforming assets can release capital, increase liquidity, and increase cash-flow.[101]

Other ways to increase cash-flow include increasing the book value of assets (step-up). This can sometimes enable higher write-offs and tax savings.[102]

Liquidity can be increased by raising additional funding that can be used as working capital or by releasing existing working capital (section 3.4). For example, the company can: introduce factoring; cut DSO and the payment terms it offers to customers; and reduce inventories. The acquirer should keep such financing

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[92] *Ibid*, § 3 number 2.
[93] *Ibid*, § 3 number 1.
[94] *Ibid*, § 3 number 1. See also § 49 number 3.
[95] *Ibid*, § 3 number 1. See also § 39 number 4.
[96] § 65 UmwG.
[97] §§ 243 and 245 AktG.
[98] § 327f AktG.
[99] § 304 AktG.
[100] Diem A, *op cit*, § 3 number 1. See also § 49 number 3.
[101] *Ibid*, § 3 number 1. See also § 3 number 18.
[102] *Ibid*, § 3 number 20.

needs in mind when negotiationg the acquisition loan facility agreement, because the normal terms of loan agreements typically restrict the raising of new debt and unusual transactions without the consent of the lenders.[103]

Debt can also be replaced with shareholders' capital. In private equity, the purpose of refinancing is, in contrast, to maximise the amount of distributable assets and distribute them to the private equity fund as soon as possible. Typically, this will be done by asset-stripping and by loading the target company with debt after the merger (see below).

Case: Private Equity and Refinancing

In practice, the legal ways to provide financial assistance are key components of the business model of private-equity firms. Their business model consists of a highly leveraged buy-out (LBO) combined with refinancing and exit.[104]

Refinancing. Perfected by private-equity firms, refinancing is increasingly being employed by non-financial firms in acquisitions. Refinancing serves two main purposes. First, refinancing enables the acquirer to finance the takeover with the assets of the target. Second, refinancing enables the acquirer to release capital after the takeover and distribute assets to investors.

In order to distribute assets to investors, the target company may incur more debt.[105] Because of the originally high leverage of the LBO, investors can earn a high return on the capital that they have invested – at least in the short term and provided that everything goes according to plan (see section 2.5).

Steps of refinancing, legal aspects, distributions, financial assistance. The steps of refinancing and its legal aspects have been discussed in the context of exit (section 10.5). It is important to keep in mind that there are restrictions on distributions to shareholders. Some legal constraints are based on provisions of company and insolvency law restricting payments by near-insolvent companies. On the other hand, refinancing is a way to circumvent the prohibition of financial assistance by the target company.[106]

Liability of banks. Where refinancing involves the sale of a debt to other debt investors, the arranging banks have disclosure duties (sections 4.5 and 4.7; for syndicated loans, see also Volume II; for information analyst, see Volume I).

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[103] *Ibid*, § 3 number 21.

[104] Locust versus locust, The Economist, May 2005: "In January, Blackstone listed a new parent company, Celanese Corporation, on the New York Stock Exchange, floating 38%. The proceeds, plus dividends and one-off fees, have so far netted Blackstone and its investors around €3.1 billion. Not bad for a capital investment last year of around €650m."

[105] See Deutsche Bundesbank, Leveraged buyouts: the role of financial intermediaries and aspects of financial stability. In: Monthly Report, April 2007 p 20.

[106] Article 23(1) of Directive 77/91/EEC (Second Company Law Directive).

20.5.4 Internal Coherence of Contracts

The terms of the acquisition agreement and the loan facility agreement form a whole for each of the three parties (acquirer, lender, vendor).

Interests of lenders, acquirers and vendors. Lenders understand that the characteristics of the target and the terms of the acquisition agreement will influence their own risk exposure.

The vendor is interested in the loan facility agreement for at least three reasons. (1) The vendor wants the acquirer to be able fulfil its payment obligations. The terms of the loan facility agreement influence the ability of the acquirer to pay. (2) The vendor needs to know about the plans of the acquirer for the target in order to protect its own reputation. (For example, selling a subsidiary for buyers to loot might cause plenty of negative publicity, ruin the value of the parent's brand, and reduce the parent's sales, and the fate of the target's employees will make future divestments easier or more difficult. Siemens got plenty of adverse publicity for the sale of its incorporated mobile phone division to BenQ after it turned out that BenQ let the division file for bankruptcy in a Munich court and continued its mobile business from Asia.) (3) The vendor should also study the representations, warranties and covenants of the acquirer and sanctions triggered by the occurrence of an event of default under the loan facility agreement. Breach of contract by the vendor under the acquisition agreement can cause breach of contract by the acquirer under the loan facility agreement. Under the terms of the acquisition agreement, the vendor may be liable for damage sustained by the acquirer. Furthermore, the acquirer will require the vendor to have delivered whatever the acquirer has promised to the lenders about the specifications of the target.

The acquirer is most clearly interested in all terms of both agreements. For example, the acquirer should pay particular attention to: the coordination of conditions precedent; the need to agree on a clean-up period; the extent of borrower discretion in the light of its business plans and exit plans; as well as the coordination of representations and warranties under both agreements.

Conditions precedent and drawdown conditions. The interaction of the conditions precedent to the financing with the terms of the sale and purchase agreement should be considered carefully.

The availability of funds is a common condition precedent to the closing of the acquisition agreement. Where it is not a condition, the acquirer/borrower should study the conditions precedent to drawing the loans and ensure that what is required is within its control. The acquirer/borrower should also consider carefully what liabilities it will incur if it fails to complete the acquisition.

The acquirer/borrower should also be aware of other events which may prevent the advance of funds (drawstops). It can be a condition to the advance of funds (payment condition, section 4.3) under an acquisition loan facility agreement that all representations and warranties under the loan facility agreement are correct and that there is no potential or actual event of default both before and after the loan is made. Furthermore, the contents of the acquisition agreement may have been incorporated into the acquisition loan facility agreement by means of an explicit reference. As compliance by the vendor with its obligations under the acquisition

agreement is not within the control of the acquirer/borrower, the acquirer/borrower can try to ensure that representations and warranties under the acquisition agreement will not influence the obligation of lenders to advance funds. Generally, where the loan facility agreement contains a payment condition, the acquirer/borrower should try to ensure that the determination of breach of contract (misrepresentation, an actual event of default, or a potential event of default) is objective. The lender would prefer a term according to which the determination of breach of contract is subjective in the lender's opinion (or, in a syndicated loan, in the agent's opinion).[107]

Clean-up period. The loan facility agreement contains terms based on the specifications of the target. For example, the warranties and covenants of the acquirer/borrower state that the target will have certain characteristics. However, the acquirer/borrower will not obtain control before the closing of the acquisition agreement, and it may take some time before the acquirer/borrower has both legal and de facto control over the target. For this reason, the acquirer/borrower will need some time after completion of the acquisition to ensure that the target is in conformity with all warranties and covenants under the loan facility agreement (clean-up period). Without a clean-up period clause, the lender might have a right to terminate the loan facility agreement immediately or take other action due to the occurrence of an event of default by the borrower.[108]

Borrower discretion. The borrower will always need to preserve a sufficient amount of managerial discretion (section 4.2). This question is even more important in the context of acquisition loan facility agreements, because the management of the target is subject even to other contractual constraints than those imposed by the lenders.

First, the acquirer/borrower (B) is often an acquisition vehicle used by an ultimate acquirer (sometimes a venture capital investor or a private equity fund) that has invested in it. The ultimate acquirer (A) has its own investors. The terms of A's own direct investment in B and the terms of the latter company's investment in the target (T) can be constrained by the obligations that A owes to its own investors. For these reasons, A will try to preserve both B's and T's managerial discretion. A will ideally want B to have enough flexibility under the acquisition loan facility for A to be able to comply with its obligations to its own investors.[109]

Second, the terms of the loan facility agreement should be consistent with A's and B's business plan for T. If they are not, actions required by the business plan will, in practice, be subject to approval by the lenders. This is because the representations, covenants, and events of default in the loan documentation are designed to give debt providers a veto right in relation to major or unusual decisions.[110]

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[107] Gayle C, Acquisition Finance – Syndication Best Practice, Int Comp Comm L R 13(8) (2002) p 303.
[108] Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) p 113.
[109] See also Gayle C, *op cit*, p 301.
[110] *Ibid*, p 302.

Third, the loan facility agreement ordinarily contains a material adverse change clause and a change of control clause. Furthermore, terms of senior loans will generally require early payment in the event of a public offering, a flotation, a listing, or a significant business sale (whether or not a change of control occurs).

On the other hand, A often has an exit plan for its investment. The provisions of the loan facility agreement and their cost implications should be reviewed in light of A's exit strategy. For example, B typically tries to ensure that the planned exit of A will not result in any obligation to prepay the loan nor any obligation to pay an early prepayment fee.[111]

Analysis of representations and warranties. Usually, the acquisition agreement and the loan facility agreement contain generic representations and warranties that can be found in both contract types as well as particular representations and warranties for each contract type.

Both contract types can contain seemingly similar representations and warranties relating to the characteristics of the target.

The representations and warranties have been described as follows: "In the context of a loan, the representations will usually cover legal matters such as due incorporation, power to carry on business, the finance documents being legal, valid and binding, no defaults under existing agreements or finance documents, no litigation, the correctness of accounts, no material adverse change since the date of the last accounts, accuracy of the information memorandum and other reports provided, pension scheme compliance and compliance with laws, ownership of assets and other representations as appropriate (for example, intellectual property or environmental depending on the nature of the business), as well as a representation that the borrower has no reason to believe that the representations under the sale and purchase agreement are incorrect."[112]

The representations and warranties under the acquisition agreement may even have been incorporated in the loan facility agreement through an explicit reference.[113]

However, the acquirer/borrower should take into account that those two sets of representations and warranties neither share the same purpose nor trigger identical remedies. Under the acquisition agreement, misrepresentations typically trigger the adjustment of the purchase price and/or a duty to pay damages. Under the loan facility agreement, misrepresentations typically entitle the lenders to stop making further advances and/or trigger an event of default. Consequently, it is important for the acquirer/borrower to ensure that the representations and warranties are suitably diluted under the loan facility agreement (for dilution, see Volume II).[114]

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[111] *Ibid*, p 303.
[112] *Ibid*, p 303.
[113] *Ibid*, p 303.
[114] *Ibid*, pp 303–304.

20.6 Shareholders' Capital

There are many ways to finance an acquisition by issuing shares. (a) Shares can be issued by the acquirer or a company higher up in the ownership chain. In the latter case, the investment of that company in the acquiring company can be in the form of debt, equity, or mezzanine. (b) Shares can be offered to the public, or the offering can be a private placement. (c) Shares can be offered to the company's existing shareholders, new investors, or the vendor or vendors as consideration for the target. (d) There can be different categories of shares. (e) Shareholders' capital can also be used as a form of acquisition financing after the restructuring of the acquirer's and the target's finances. (f) And finally, the acquisition can be financed by issuing shares before closing, at closing, and in the context of restructuring after closing.

Shares as a source of funding in general. Where the acquirer issues shares to its existing shareholders or third parties who subscribe for those shares for a consideration in cash, the acquirer obtains funds which enable it to pay the purchase price in cash (for the legal aspects of shares as a source of funding, see section 5.10).

Shares as a means of payment. Where the acquirer issues shares to the vendor as consideration for the target, the acquisition will be funded by the vendor, and the acquirer needs to raise less financing from other sources.

The vendor is used as a source of funding in two cases: where the transaction is a merger and the consideration consists of shares in the acquirer (as the company that survives the merger); and where the vendor subscribes for shares in the acquirer in consideration for shares in the target (share deal) or the target's business (asset deal).

Whereas mergers are subject to mandatory provisions of law that protect the shareholders of each participating company (section 10.4.2), the issuing of shares to third parties is constrained by existing shareholders' rights and mandatory provisions of law that protect both shareholders and creditors (section 5.4).

In both cases, the vendor may regard the transaction as an acquisition of a block of shares in the acquirer. In that case, the vendor may require typical representations, warranties and covenants. This can raise some particular legal questions.

First, the enforceability of the acquirer's representations, warranties and covenants that relate to the acquirer itself and its business may be constrained by requirements as to form applicable to the subscription of shares in general, the subscription of shares against a consideration other than cash, or mergers.

Second, the enforceability of sanctions for breach of contract by the acquirer may be constrained by restrictions on the distribution of assets to shareholders in general or a particular shareholder.

Shares as a form of financing after restructuring. In a share deal, the target company is often loaded with debt after a leveraged buyout and the merger of the acquiring company with the target company. In an asset deal, the acquiring company may be loaded with debt. In order to reduce leverage or enable the exit of the ultimate owners of the acquirer, shares may be issued to investors (section 5.10).

The issuing of shares may take the form of an IPO, a private placement, or a joint venture.

20.7 Mezzanine

Mezzanine capital can close the gap between traditional shareholders' capital and debt financing. As explained in Chapter 6, mezzanine financing can consist of debt mezzanine or equity mezzanine instruments. In other words, the "equity technique" means that debt instruments are made to behave more like shares and shares more like debt instruments (section 5.1). Mezzanine financing can complement traditional sources of financing where the acquirer's capital requirements are substantial or the acquirer needs flexibility when structuring its financing mix. Mezzanine capital is popular even in the expansion phase of the firm.

Mezzanine loans. The buy-out transaction may only justify a limited amount of senior debt on typical senior debt margins, fees, and gearing. If further debt is required to fund the acquisition, mezzanine debt may be available at a higher price.[115] In large transactions, mezzanine debt can form an important part of the funding package.

For lenders, mezzanine loans are a source of additional arranging and other fees. They are also a source of higher margins.[116] In addition, mezzanine loans can bring other benefits. There is typically a component that enables mezzanine lenders to benefit from the increase of the value of the target's shares. The firm should take the cost of those benefits into account and should also investigate whether the benefits can reduce the margin.

The margins are higher because of the use of subordination techniques. Typically, mezzanine loans are subordinated in the event of insolvency (but not to the extent that their ranking falls as low as that of the claims of shareholders).[117] In addition, mezzanine loans will have a longer maturity compared with senior loans and may have a 5 to 10 year term. There is generally a one-time payment at the expiry of the loan term (bullet repayment) often combined with early prepayment premiums. Like mezzanine debt itself, collateral will typically be subordinated. Mezzanine loans can benefit from security from the target company or security and guarantees from target group companies, ranking behind the senior loans.[118]

Where investors expect the value of the acquirer to increase, investors may prefer to get their share of it. This can be achieved through an "equity kicker". The equity kicker can be real or synthetic.

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[115] Gayle C, Acquisition Finance – Syndication Best Practice, Int Comp Comm L R 13(8) (2002) p 300.

[116] *Ibid*, p 301.

[117] For example, in Switzerland, contracts are drafted so as to avoid subordination as defined in Art. 725(2) OR (Obligationenrecht, the Code of Obligations). See Barthold BM, Mezzanine-Finanzierung von Unternehmensübernahmen, SZW/RSDA 5/2000 p 232.

[118] Gayle C, *op cit*, p 301; Diem A, *op cit*, § 38 number 20.

Real equity kickers such as share option rights, conversion rights, or transferable warrants can give the mezzanine lenders a share in an equity upside. Where the equity kicker does entitle its holder to subscribe for shares, the firm must comply with particular company law rules – rules on the issuing of share option rights or similar rights; rules on the increase of the number of shares; rules on the pre-emptive rights of existing shareholders; and, in most cases, rules on the increase of the legal capital of the company (section 5.4).[119]

For example, when a German AG issues warrants, it must create "conditional capital" (bedingtes Kapital) in anticipation of the exercise of those rights.[120] The creation of conditional capital must be authorised by a qualified majority of three-fourths at the general meeting.[121] In contrast, a German GmbH cannot create conditional capital. Instead, a GmbH could in principle decide on an increase in capital and the waiving of pre-emptive rights.[122]

When a mezzanine investor exercises his share option rights, conversion rights, or warrants, the ownership structure of the company will change. In order to avoid it, the firm and its owners often ensure that the equity kicker may be exercised immediately before an IPO or a trade sale and may not be exercised earlier.[123]

Alternatively, the controlling shareholders of the firm and the mezzanine investors can choose a synthetic equity kicker such as a "tag-along right" (see below) or a "back-ended fee" (see below). Synthetic equity kickers neither entitle their holders to subscribe for shares nor dilute the existing ownership of the firm.

A tag-along right is triggered in the event of the sale of the controlling block in the firm. A tag-along right can consist of an obligation of the controlling shareholders to ensure that mezzanine investors will have an option to sell their mezzanine instruments to the buyer of the controlling block at the same price per instrument as the price paid for each share.[124]

A back-ended fee is an additional payment on top of the purchase price. It will be made after the expiry of a certain period of time on the basis of the performance of the firm.[125]

The amount of share option rights or conversion rights is set to provide the lenders with a target rate of return on their investment based on the loan yield plus the value of the equity kicker.[126]

Equity mezzanine. In acquisition finance, mezzanine loans (that is, subordinated debt instruments with an equity component) are more common than mezzanine

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[119] For Swiss law, see Barthold BM, *op cit*, pp 228–230.
[120] § 192(1) AktG. For the contents of the decision to create conditional capital, see § 193 AktG.
[121] § 193 AktG. This fulfils the requirements of the Second Company Law Directive. See Articles 25 and 29 of Directive 77/91/EEC (Second Company Law Directive).
[122] §§ 53(2) and 54(1) GmbHG.
[123] Diem A, *op cit*, § 38 number 16.
[124] *Ibid*, § 38 number 17.
[125] See, for example, Barthold BM, *op cit*, pp 226–227.
[126] Diem A, *op cit*, § 38 number 15; Gayle C, op cit, p 301.

shares (that is, shares that are made to behave more like bonds) or other forms of equity mezzanine. Popular forms of equity mezzanine include preference shares,[127] German-type participatory rights (Genussscheine), and US-type preferred stock, such as Swiss-type participation certificates (Partizipationsscheine).[128]

Restrictions on the distribution of assets to shareholders may restrict the terms of equity mezzanine. For example, the acquirer cannot provide collateral for the security of Swiss-type mezzanine participatory certificates or repay them without observing restrictions on the repayment of paid-up capital and provisions that prohibit actions that are not compatible with the purpose of the corporation.[129]

[127] For Swiss law, see Art. 654 OR (Vorzugsaktien).
[128] For Swiss law, see Art. 656a OR.
[129] Art. 656a(2) OR. See Barthold BM, *op cit*, pp 224–237.

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