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The Road to Harmonization in the EU

Implementation of takeovers directive has given way to patchwork of rules.

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THE VOLUME of cross-border mergers and acquisitions in Europe has soared in the last 12 months. Behind this general surge in activity lies a host of conflicting regulatory and market changes. The EU Takeovers Directive, adopted in 2004 with the objective of harmonizing takeover codes across the European Union, has during the course of 2006 been implemented by most EU countries. Nationalist protectionism has influenced many countries' implementation of the directive, however, and the nature of that implementation has differed markedly from country to country. The result has been a complicated patchwork of rules that leaves European rules in this area far from harmonious.

Protectionist forces have been countered by a concurrent rise in shareholder activism, in part reflecting the emerging global clout of hedge funds and mutual funds. Private equity funds have also become increasingly active in cross-border deal-making, including through unsolicited offers. The interplay between the changing regulatory environment, nationalist protectionism, shareholder activism and the growing boldness of private equity players has created both opportunities and problems for prospective U.S. acquirors.

EU Terrain Uneven

The landscape for M&A in Europe has never presented a homogenous terrain. For the past 30 years, the UK has operated a free market regime in the M&A sphere, marked by an absence of controls on changes in ownership and the progressive privatization of most companies in the former state sector. The UK's Takeover Code prohibits many of the abuses that led to the invention and acceptance of defensive techniques in the United States. Front-end loaded offers, offers conditioned on the arrangement of financing, creeping takeovers, and squeeze-outs with less than 90 percent acceptance are all prohibited. Defensive measures—often referred to as "frustrating action"—are also prohibited. A UK company subject to a bona fide fully financed offer must allow its shareholders to accept or reject it. There are also virtually no barriers to foreign acquirors, and in recent years foreign bidders have acquired a significant portion of the UK utilities, manufacturing and banking sectors with almost no governmental intervention.

In contrast, the social market economies of many Continental European regimes, where the state and organized labor are viewed as important stakeholders in corporate affairs, have adopted a more interventionist and protective approach. Governance structures in the Netherlands, for example, have always served as a substantial impediment to unsolicited acquisitions, and French, German and other Continental nations' regulatory frameworks have been only marginally more hospitable. In some countries freeze-outs had been impossible until recently, and consultations with labor union representatives and (in high-profile cases) government officials were, and remain, a necessary facet of the takeover process. Unsolicited takeovers in these jurisdictions have in the past been rare, with good reason.

The structure of ownership in the UK and Continental Europe is also very different. While the shareholder base of listed companies in the UK has for many years been dominated by institutional investors, in Continental Europe continuing government ownership, cross-shareholdings and pyramid structures have often resulted in companies being controlled by shareholders with more complex interests. Labor is often represented at the board level (as in Germany) or in "works councils" (France), and is often provided statutory rights in the event of a takeover (as in France).

Rampant Protectionism

Against this backdrop, the last couple of years have seen some notable examples of rampant protectionism on the Continent, often clothed in concepts such as "national interest," "economic patriotism" or "the need to create national champions."

In France, there has been overt state intervention at the highest level, for example to prevent the 2004 acquisition of Aventis by Novartis (pushing Aventis into the arms of Sanofi) and Suez by Enel, with the merger of Suez and Gaz de France being brokered by the French Prime Minister. The concept of "national interest" has always been a peculiarly flexible concept in France. The intervention in the Novartis/Aventis situation was ostensibly to sustain French defenses against bioterrorism, and the list of activities which are of such significance that government consent is required for foreign acquisition rather improbably includes casinos. Cynics suggest that this was prompted by the fact that Danone (then under siege from PepsiCo) owns casinos and the need to create a national yogurt-making champion was not a sufficiently compelling argument.

France is not alone. The Endesa/Gas Natural/Eon situation in Spain (with the law being changed to empower the national regulator to block a foreign bid, prompting action by the European Commission for breach of EU market rules) and the ABN Amro/Banca Antonveneta saga in Italy are but two of many examples.

Britain has not joined in this trend. Over the last 12 months P&O, Associated British Ports and British Airports Authority (companies where there are legitimate national interest considerations), together with key industrials like BOC and Pilkington, have been sold to foreign acquirors with barely a whisper of dissent. Even the initial hesitation by Prime Minister Tony Blair and Chancellor of the Exchequer Gordon Brown over the potential acquisition of Centrica (the largest UK gas supplier) by Gazprom (the Russian state utility) was soon cast aside.

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Implementation of Directive

The adoption of the EU Directive was meant to harmonize the takeover laws of the EU countries. With its implementation this year, it was hoped, the protectionist policies of Continental Europe would converge toward the laissez faire policies of the UK. Reality has proven more complicated.

In some areas the directive's implementation has brought much needed clarity and consistency. Every member state has (or, in the case of a few stragglers, will soon have) a statutory takeover regime, providing for clear rules in relation to takeover offers. Those statutory enactments will require: the equal treatment of all holders in the offer; minimum (14 days) and maximum offer periods; the prohibition of bids that are not fully financed; and that all offers are publicized through an offer document that will obtain mutual recognition throughout the EU.

As a result of the directive, freeze-outs of minority interests following an offer have become possible in all member states, based on the acquisition of (depending on the country) 90-95 percent of the target's shares. Every EU state will now require persons or groups who have acquired a level of ownership presumed to convey control (30 percent or one-third in most jurisdictions) to make an offer for the balance of the shares. Any minority shareholder who declines to tender in a successful offer will have the right following the offer to require the bidder to buy his shares at the bid price, thus allowing shareholders to decide not to tender without fear of being left behind.

In two areas efforts at harmonization broke down, however: the proposed prohibitions on defensive measures, or "frustrating action," in response to an offer (contained in Article 9 of the directive) and the suspension of multiple or restricted voting rights so as to allow offers to overcome complicated governance structures (the so called "breakthrough" provision in Article 11). In order to obtain passage of the directive, member states were given the ability to opt in or out of these two contentious provisions.

Some states have opted in, others have opted out, and some have opted into one but not the other. The UK has opted into Article 9, for example, as its Takeover Code already precludes defensive actions, while opting out of Article 11, even though two-tier voting structures are rare in the UK. Germany has opted out of both, although the significance of its opt-out is largely political as there are few defensive measures (such as rights plans) available to German companies, and a number of German companies are considering whether to opt back in as an investor relations matter. The Netherlands, which in contrast permits a range of defensive mechanisms, has opted out of both, although a very limited breakthrough mechanism may be introduced into Dutch law. It appears that Italy may opt in to both.

'Reciprocity'

The optional nature of two key provisions in the directive has given rise to a concept—"reciprocity"—which has assumed a significance way beyond what appears to have been originally intended. A member state opting out of the Article 9 frustrating action and/or Article 11 breakthrough rules must allow companies in its jurisdiction to opt back in and submit themselves to Articles 9 and/or 11. The directive then allows those companies, when opting back in, to limit the effectiveness of that opt-in to bids by companies that have similarly opted in. Although the language of the directive does not seem to permit it, several countries have expanded this concept to mean that Articles 9 and/or 11 will only apply to offers from companies or jurisdictions that have similarly opted in to these (or equivalent) prohibitions against defensive mechanisms.

France, for example, has opted in to Article 9's ban on frustrating actions, but has imposed a reciprocity requirement, and Italy and Spain appear likely to follow suit. As part of the implementation package in France, moreover, Parliament authorized French companies to defend themselves against bidders from jurisdictions that allow defensive measures by adopting a statutorily-approved "poison pill." The poison pill takes the form of rights plan-like warrant, similar to a warrant that Aventis had attempted to issue during the earlier Sanofi bid (but was prevented from doing so by the Bourse). The warrant needs shareholder approval but has already been adopted by Bouygues, Suez and Eurazeo. It remains to be seen how many other companies will follow their lead.

This requirement of "reciprocity"—at least as interpreted in the new French legislation—may create significant hurdles for U.S. bidders, bidders from other countries that permit takeover defenses, and all private companies, none of whom can, in the French statutory nomenclature, be deemed "virtuous" (i.e., subject to the equivalent of Articles 9 and 11).

A U.S. bidder with a rights plan will clearly not be considered virtuous, and the "virtue" of a U.S. bidder which has not adopted a rights plan but has the ability to do so is also in question. U.S. bidders will, therefore, operate at a disadvantage to bidders from EU countries that have opted in, who have no defenses themselves and are thus deemed virtuous. This problem is unlikely to be limited to France. There are ominous signs that this approach will be adopted by many member states, with the result that U.S. bidders will be at a competitive disadvantage in contested takeovers in many European jurisdictions. Only the UK has eschewed this approach; all bidders are welcome, virtuous or not.

While the implementation of the Takeovers Directive has fallen short in its effort to eliminate barriers to cross-border acquisitions, the shortcomings in its implementation may in retrospect be viewed as a rear-guard action against an inexorable rise in cross-border deal flow. Key factors supporting the increase in cross-border deal volume are the roles of activist investors and of private equity acquirors.

Rise in Shareholder Activism

There was a time when investors in Europe were reliably supine, and would support incumbent management in all but the most extreme cases. Times have changed. Shareholders are now influencing M&A in Europe in a way that would have seemed inconceivable 20 years ago: by seeking to prevent deals or by encouraging them and putting companies into play.

Some of the most outspoken activist investors have their roots in the United States, but there are home-grown activists as well. In some situations, superficially unlikely alliances of traditional European institutional investors and Cayman Islands-based hedge funds have teamed up to pressure blue chip European corporations. Unsurprisingly, attitudes to hedge funds vary: for every member of the corporate establishment who views them as "locusts" there is a long fund which relies on them for the quality of their research.

This year's prime example of the influence of activist investors on a contested takeover is Mittal's ultimately successful effort to acquire Arcelor. Initially rejected by both the French company and government, Arcelor faced increasing pressure from shareholders in the face of Mittal Steel's increasingly attractive offer price. Arcelor responded by seeking a white knight in the somewhat unlikely form of the Russian steelmaker Severstal, and sought to pursue a transaction that it could in theory push through with only indirect shareholder acquiescence. With a further enhancement to Mittal's offer price, Arcelor faced a shareholder revolt, and was ultimately forced to accept the Mittal offer.

In other cases in the past year activist shareholders have played an influential role both encouraging transactions (such as NYSE/Euronext) and preventing deals (such as the VNU/IMS and Deutsche Börse/LSE situations).

The growing influence of activist investors has caused regulators to take note. In the UK, the Takeover Panel has recently extended its rules governing disclosure of market purchases during an offer period to include contracts for differences (CFDs), derivative instruments that have been the instrument of choice for hedge funds and activist investors in building up stakes in listed companies, in part because they had been exempt from disclosure. Investors not contemplating an offer can continue to purchase CFDs without disclosure outside an offer period, although there is an increasing clamor for the closure of this regulatory loophole. It is estimated that around 40 percent of trades in the London market are in CFD form.

Although U.S.-style proxy battles are extremely rare in Europe, the law in many jurisdictions provides shareholders with considerable scope to influence corporate behavior. In the UK, for example, holders of 10 percent of a listed company's shares can requisition a shareholder meeting at any time, and directors cannot be entrenched, so executives ignore a large disgruntled shareholder group only at their peril.

Influence of Private Equity

Private equity houses have also played an increasing role in driving cross-border M&A in Europe. Often based in London, but also in Frankfurt, Amsterdam and other European financial capitals, private equity houses have increasingly taken aim at European listed companies. Private equity has traditionally been reticent to pursue transactions on an unsolicited basis, believing that an unsolicited approach would be inconsistent with the close relationship between equity sponsor and senior management that often underpins a leveraged buyout. Recent transactions have suggested a new willingness among some private equity groups to make offers, however, to European companies even in the face of some initial resistance. Many of the private equity groups are flush with cash from recent fund raisings, and see underperforming listed companies as appropriate takeover targets.

In the last 12 months, there have been several unsolicited offers by private equity groups. As a result, even some of the leading names among UK listed companies have begun to worry that they could become the subject of unsolicited offers from private equity houses.

The combination of rapid regulatory change, protectionist impulses in political and business circles, increasing shareholder activism and the growing willingness of private equity groups to pursue listed companies, even on an unsolicited basis, has made for an interesting period in cross-border European M&A. The landscape is changing. Its future contours are yet to be clarified.