C/M/S/ Bureau Francis Lefebvre

Mergers & Acquisitions 2

NEWSLETTER

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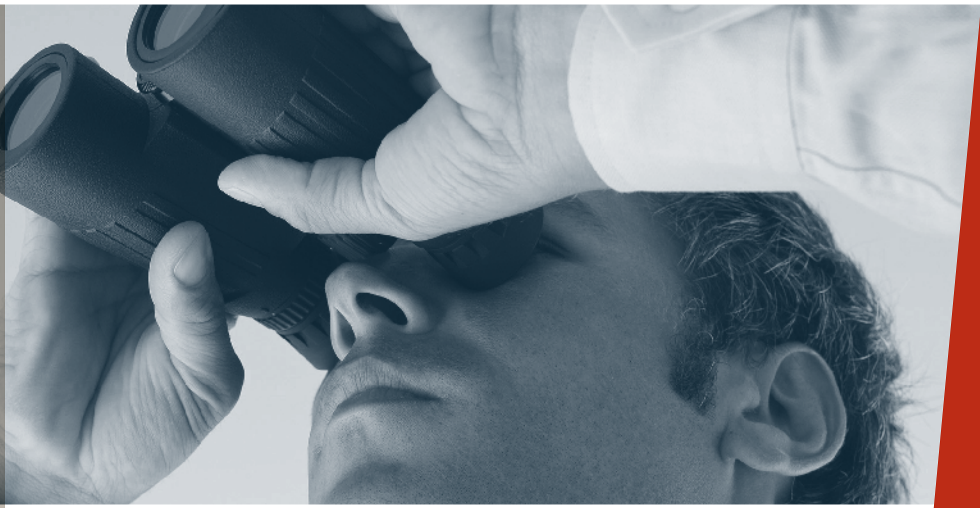

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Editorial

The current period is hardly favourable to mergers and acquisitions, but it would be wrong to regard the sector as having been mothballed for several months. In terms of practice, there have been a number of developments.

As shown by a European study of mergers and acquisitions, recently carried out by CMS*, the trends that had been observed in 2008 have hardened in 2009. These include amongst others the downward pressure of the economic slowdown on prices and valuations, and the shifting balance of power between buyers and sellers, with sellers demanding more and more guarantees.

In good times everything seems possible, and a kind of consensus eventually emerges in which the legal fundamentals can be forgotten. The return of difficult times has led practitioners to take full account of legal risks once again, after a period in which they had been gradually overlooked. Accordingly, the main article of this newsletter is devoted to certainty and security in relation to finance. This an area where CMS Bureau Francis Lefebvre has been particularly active, with some 40 assignments carried out in each of the last 3 years. It is never inconceivable that a particular assignment will turn out to be a dead end, but this conclusion is only reached after the issues have been exhaustively analysed.

In such circumstances, 2009 will undoubtedly be a year when lawyers return to the forefront in the process of mergers and acquisitions, and the renewed focus on legal rules should allow the market to be rebuilt on firmer foundations for the future.

The CMS Bureau Francis Lefebvre Corporate Team

*CMS European M&A Survey 2009 - www.cms-bfl.com, www.cmslegal.com

Alerts

Remuneration of senior management and change of control

A change of control in a company may be a ground for payment of compensation to a manager, where the manager has to cease work according to the new dominant shareholder's wishes. In addition, adjustments to company capital may raise issues over pre-existing payment obligations, such obligations often having been entered into in circumstances which judges are more and more apt to question.

Both of these points are illustrated by recent events.

• Change of control and payment of compensation

The AFEP-MEDEF recommendations on management pay address the question of compensation on departure (or golden parachutes) and lay down that such compensation should be limited to two years' remuneration, including both fixed and variable remuneration.

This ceiling applies to the entire remuneration package and includes in particular any sums paid under a non-competition clause.

The payment of such compensation is only possible in the case of a forced departure related to a change of control or a change of strategy. Hence a cessation of trade can still justify a departure payment being made to a manager.

• Revisiting pay packages upon change of control

Caselaw provides a recent example of the consequences of capital restructuring on certain supplemental pension arrangements which had previously been made by the company in question. The judge declined to enforce Carrefour's agreement to make payments to its former CEO under such an arrangement. The reason for Carrefour's own refusal to carry through the agreement lies no doubt in the arrival of new shareholders. The Paris Court of Appeal held, in its judgment of 7 October 2008, firstly that the benefits in question did not meet the requirement of proportionality, and secondly that the obligation undertaken by Carrefour should have been authorised in advance by the Board, and put to a shareholders meeting for approval.

To end with a further example, though not one linked to control, on 3 December 2008 the Nanterre Commercial Tribunal gave judgment in the Rhodia matter. The Tribunal ordered the Chairman of the Board and the Director-General of Rhodia to refund the settlement payment accorded to former CEO Jean-Pierre Tirouflet on the ground of termination of his service contract. While the dense and somewhat obscure judgment is difficult to analyse, it is clear that the general distaste for compensation linked to the end of a term of office must be reflected in great caution.

> SPECIAL REPORT

Financing acquisitions: restoring the seller's protection

Good times are generally times of scant legal protection. In a period of collective success, nobody wants to be weighed down by legal constraints which seem outmoded and which impede the quest for maximum profit. In a period of economic crisis, on the other hand, legal considerations return to the forefront, and rigour becomes a fundamental requirement once again. The financing of M&A and/or LBO transactions is a remarkable illustration of this general observation, with sellers having particularly suffered as legal issues became somewhat marginalized.

1 - Until very recently, it was not very difficult to find finance to take control of a company. Credit was readily available, and the buyer could play the banks off against each other in order to obtain the best terms and conditions and the best rates. The equity/debt ratio was adjusted for maximum leverage, and several tranches of debt were created. An ever larger portion of this debt was interest only borrowing, and therefore, in reality, repayable by the buyer under an anticipated future sale. The amount of leverage, especially in relation to the interest-only borrowing, was such that repayment became a relatively academic obligation. Risk seemed a remote consideration, especially since the seller hoped to resell the business quite rapidly, on the basis of a higher multiplier. The new buyer would of course add new debts to the various debts which already existed. This upward spiral, based on collective confidence in the future, generated profits which were somewhat detached from the fundamental economic realities. In its mechanics, it resembled a speculative bubble, or at least it offered little stability in the event of setbacks.

2 - Undoubtedly, the legislature sensed that systematic borrowing created risks which needed to be controlled. A good example of this awareness is found in the law, albeit strictly a tax law, on under-capitalization1. This measure however was of limited scope, and although it did lead to a reconsideration of LBO schemes, its sanctions had little deterrent effect.

3 - All therefore seemed in order so far as the law was concerned. Nevertheless, clear analysis revealed much that was unsatisfactory in the law, especially from the seller's point of view. It is useful to seek to identify these imperfections (below, section I) before considering how to put the relationships on a firmer legal footing for the future (section II).

> SPECIAL REPORT

Financing acquisitions: restoring the seller's protection

I – Uncertainties in finance which have thus far prejudiced the seller

4 - The problems achieving certainty and security in relation to finance derive mainly from four factors, each of which can be relatively easily recognized. These are: the bilateral nature of the finance relationship, which involves only the buyer and the financier; the widespread abuse of discretionary provisions by lenders; the use of structures which undermine any practical legal remedy; and the lack of any systematic use of conditions precedent, such that transactions fail to reflect the commercial reality.

Bilateral nature of the finance relationship, involving only the buyer and the financier

5 - Logically, finance for taking control of a company should involve three parties: the buyer, the seller and the financier. This has been far from the norm to date, however. Finance houses only deal with their client, the buyer. The seller is not involved in the process. In the event of default by the lender, the seller has no recourse because there is no contractual relationship between seller and lender. This is so, at least, unless inspiration can be drawn from a recent judgment of a Full Court of the Court of Cassation3, which has opened up a new route to compensation by allowing third parties to seek, on the basis of article 1382 of the French civil code, compensation for damage caused to them by the breach of obligations contained in a contract. From now on, in fact, "every breach of contract which causes damage to a third party gives rise to an obligation on the part of the contract-breaker to make reparation for that damage"4.

Abuse of discretionary provisions by lenders

6 - Discretionary procedures have become embedded to a startling degree in the practice of business transfer. Here, in no particular order, are some examples: in relation to mandates and term sheets, everything is drafted so as to turn on everything else, and the supply of funds depends on many factors. These include declarations and production of documents or legal opinions which the lender must consider satisfactory, in terms of substance as well as form. The reality is that arbitrary and subjective factors may arise at any time, and may entitle the lender to withdraw. The lender may not be satisfied with the legal opinion of the buyer's advisers, or the auditors' reliance letter; the seller's advisers may refuse to play insurer by giving their own legal opinions to the banks; or the owner-managers may refuse to give the most widely drawn declarations and warranties. In each case finance may be refused. These ostensible reasons for refusal may conceal other rationales.

7 - A further example of a discretionary provision is often to be found in the drafting of Material Adverse Change ("MAC") clauses. According to many practitioners, such clauses are becoming more widespread in acquisitions and are beginning to appear in mergers. In the former case, the insertion of a MAC clause is clearly appropriate because of the delay between the execution of the contract ("signing") and its completion by the transfer of shares ("closing"). During this period, which may be relatively long in the case of a complex transaction, the buyer is at risk. To mitigate this risk, the parties may agree on how the business is to be managed, through ordinary course of business or price adjustment clauses. These precautions, however, do not address the possibility of a fundamental deterioration in circumstances. From time to time very widely drafted MAC clauses have been seen, intended to catch anything and everything that might occur. Paradoxically, these have been so wide that they have not come into play (or only to a limited extent) since the downturn began. Too much theoretical discretion undermines practical discretion, and this is why the banks eventually accepted firmer obligations in relation to supply of funds, imposed through the mechanism of certain funds periods.

Use of borrowing structures which leave the seller without a practical remedy in the event of default

8 - The borrowing entity is still often a shell, lacking substance, and sometimes located abroad. Thus, seeking redress in the event of a default is a rather haphazard process. This is compounded by the fact that, in general, the finance is structured in such a way that there is no recourse against shareholders.

In order make the seller's position a little more secure, it has certainly been possible to obtain commitment letters from lending institutions, or from the borrower's holding company, where this is not contrary to local regulations, or impossible because of the structure of the finance package or its particular terms. However, such letters are generally comfort letters with little or no binding force.

Lack of any systematic use of conditions precedent in acquisition contracts

9 - Bearing in mind the certain expectation that finance would be obtained, this was rarely made a condition precedent to the sale. This situation did not reflect the realities of transactions that relied on external finance. Practically speaking, the legal risk rested entirely on the seller in such a case, which was not the intention. Take an acquisition contract which is subject to a single condition precedent: authorization or non-objection by the competition authorities; assume that this condition is fulfilled but that finance is not provided. According to the simplest reading of civil law, it is based on consensual principles, and payment of the price is incapable of being a condition precedent of a sale, because it is necessarily a consequence. Hence the sale must be considered as having been made, even if the transfer of property is deferred pursuant to other clauses of the contract. In such a case, we find ourselves in a grey area of the civil code, somewhere between sale and transfer of property. The seller's only way out is to ask the judge either for specific performance (which can be an uncertain route, given that the relevant company is often a mere shell without any fully effective remedy against shareholders, or indeed against the defaulting lenders) or for judicial rescission of the sale, freeing the seller from all obligations. Here, there is the risk that the buyer and its advisers will obstruct the application so as to buy time to arrange alternative finance.

10 - We are now in a new environment; the field of possibilities and analysis has re-opened, and the mechanisms contained in the civil code are being rediscovered, along with its rigour. In this uncertain environment, where rationality is displaced by the emotion of fear rather than that of enthusiasm, there is a prospect of achieving maximum security for the seller in terms of the solidity of the finance, the solidity of the borrower, and the delivery of funds at the appropriate time. In reality this benefits all parties, and requires processes for dealing in early course with many aspects often left for the later stages of the transaction.

II - More certainty and security of finance

11 - Legally, it is possible to rethink the relationship between buyer, seller and financial institution, so as to address the deficiencies identified above. This is a starting point for re-introducing protection.

Substituting a genuinely tripartite relationship for the current bilateral relationship

12 - In principle, the financial institution negotiates its mandate and the terms and conditions of the tearm sheet with its sole client, the buyer. It does not undertake any obligation in relation to the seller. Nevertheless, while it is the buyer who pays charges such as the commitment fee and the arrangement fee, nothing prevents the bank's obligations being undertaken vis-à-vis the seller as well. In fact, it is usual in practice to call on the seller and his advisers to produce legal and financial documents, and to assist in the arrangement of the finance. Equally, it is quite common to "parachute" managers into the acquiring vehicle on the day the transaction is executed, so that they can sign the finance documentation produced by the buyer and its advisers, and take responsibility for it in one way or another, if only through "bad leaver" clauses in shareholder agreements

13 - Furthermore, nothing prevents a contract being signed instead of a mandate letter. Under such a contract the bank could undertake, to both seller and buyer, to put the intended finance in place by a certain date, that date having been fixed by mutual agreement between all parties. Ultimately, such concrete obligations can benefit all parties, since in the case of default, the seller suffers a loss just as significant as that of the buyer.

14 - The terms and conditions of term sheets must be given attention from the outset, not least by the seller's advisers, so as to limit the scope of the requests which follow. These again can create uncertainty during negotiations and, if they prevail over common sense and balance, can result in standard form contracts whose individual terms are non-negotiable, and which are markedly skewed. In such cases the borrower may be in breach of contract from the moment of signature.

Preventing arbitrary contractual behaviour

15 - While current practice (in particular the Terms Sheet) means that the legal position depends on many matters of discretion, an attempt can at least be made to reduce the amount of discretion involved. As far as possible, it should be agreed at the outset what standard documents - including advisers' legal opinions, reliance and release letters - will be deliverable on closing. This avoids skirmishes along the lines of "if I don't have such-and-such a document and such-and-such an opinion, I won't be advancing the finance".

16 - MAC clauses, adverse event and significant change clauses, when these are incorporated in the documents, must be better drafted so that their interpretation is less subjective. Besides the question of what kinds of event trigger the right to rescind, invoking a MAC clause raises further issues. In practice, it is generally provided that both parties will have the right to rescind. This right is most often exercised by the buyer, on the basis of a fundamental change affecting the transferred business, but it can also be relevant to the seller. The seller may be concerned that the transfer price could be significantly reduced in the event of an adverse change, by the operation of a price adjustment clause or a liabilities warranty. The right to rescind should therefore be exercisable without reference to the buyer. This said, the risk of rescission being blocked by the buyer is limited, because the changes which engage the clause are, by definition, outside the parties' control.

Financing acquisitions: restoring the seller's protection

More protection in the transfer contract

17 - Several avenues can be explored, and only the most important will be mentioned.

18 - One approach would be to increase the amount of protection which is available even before legal formation of the sale contract. Use could be made of conditions precedent, and in particular, proof of the availability of funds could be made a condition precedent. The advantage of this approach is that the contract of sale is not formed unless and until such proof is given.

19 - A second avenue which seems open, in the absence of caselaw to the contrary, is the use of retention of title clauses. On this approach, the transfer contract becomes a kind of pre-contract, under which the sale and transfer of property are subject to actual payment of the price. It must be said though that this line of thinking, having been opened up some years ago by various authors5, has always met with reticence from practitioners.

20 - In reality, the main use of retention of title clauses is to enable the seller to assert ownership in the event of a collective insolvency procedure. In other circumstances it is of less interest, as the contract of sale has clearly been constituted despite the non-payment of the price. In practical terms, retention of title can undoubtedly secure the debt due to the seller. Still, a sale has taken place, and consequently there is an issue as to the circumstances in which the shares can be resold.

21 - A third approach would be to provide for a sanction in the event of default by the buyer, by attaching a cost to such a default. This could be done by means of a penalty clause or lock-in payment, amongst other devices. These clauses could themselves be supported by guarantees or indemnities. Looked at like this, it is striking how the transfer of shares and the transfer of real property use very different contractual structures, even though the applicable sales law is one and the same. Each of these transaction types may be influenced by developments in the other.

22 - Finally, provision could be made for rescission of the contract, in the event that the sale is not completed on the intended date. This could be an effective form of protection. Is it realistic, though, to envisage automatic rescission clauses which operate where the conditions precedent to the sale are fulfilled, and the sale is to be regarded as having occurred under the principles of the civil code? In theory this kind of consensual rescission is possible, rescission taking effect upon notice. Under the general law applicable to rescission clauses, the ground of rescission has to have been specified in the clause itself. There are judicial decisions upholding rescission insofar as the creditor has acted in good faith[9].

23 - Going further, an automatic rescission clause could be combined with provision for compensation to be paid by the defaulting buyer. This would be a penalty clause and therefore susceptible to review under article 1152 of the civil code. Particular care should be taken over the drafting of such clauses. The First Civil Chamber of the Court of Cassation has held that such a payment is due only in the circumstances stipulated in the transfer, and can be avoided where the party in question is not categorically refusing to execute the transfer[10]

24 - While nothing is impossible, habits of practice and ingrained routines do mean that not everything can be achieved, at least not in the desired timescales. Nonetheless, the current climate is favourable to new thinking, and the time has undoubtedly come to be creative once again.

1. Finance Law for 2006, applicable to accounting years beginning on or after 1 January 2007
2. Estelle Dion and David Affejee, Bulletin fiscal Francis Lefebvre (Francis Lefebvre tax bulletin) March 2006.
3. 6 October 2006, RJDA 1/07 No. 18. See also Cass. com. 18 December 2007, RJDA 3/08 No. 232
4. Isabelle Arnaud-Grossi and Jacques Mestre "Can the mainstays of company law hold out for long against tortious liability for simple breach of contract?" Revue Lamy Droit des affaires – February 2008 No. 24 p.10
5. Pierre Mousseron "Retention of title clauses in transfers of rights in companies" Droit des sociétés Actes Pratiques March/April 2004 p.1
6. Mousseron, op. cit.
7. Cass. com. 24 September 2002, Bull. Joly Companies 2002 p. 1320, RJDA 2003 No. 602
8. Jacques Mestre, Lamy Stés commerciales 2008 No. 1015 p. 499
9. Cass. civ. 3e 25 January 1983, Bull. civ. III No. 21
10. Cass. civ. 1ère 12 October 1982, Gaz. Pal. 1983 Section I, p. 83

Recent Developments

1 / Calculation of the numerator for the purposes of notifiable holdings

Though they follow on from the AMF working party's consideration of declarations of notifiable holdings and declarations of intention, the measures adopted in the regulations of 30 January 2009 are moderate by comparison with the working party's initial recommendations. On the question of how the numerator should be calculated for the purposes of determining notifiable holdings, they provide that options are now to be taken into account. This is so whether the options are in the money or out of the money, and whether they are European or American, provided that their exercise depends solely on the holder (knock-in options are therefore excluded). On the other hand, where the holder's right to receive the underlying asset can only be exercised in circumstances which, even in part, are outside his control, a separate declaration is to be made. In relation to instruments which can only be settled in cash, the separate declaration approach is again followed.

2 / Declarations of intention

In connection with declarations of intention, it was first decided to increase to four the number of thresholds triggering the obligation to make a declaration. The thresholds are 10%, 15%, 20% and 25%. As far as the actual content of these declarations is concerned, the regulations require additional information relating to the "mode of financing the acquisition", the "intended strategy of the person making the declaration in relation to the issuer, and its implementation", as well as "any temporary transfer agreement relating to shares or voting rights". To compensate for these more stringent obligations, the regulations reduce the period during which they apply from 12 to 6 months. In the event of a change of intention during this period, a fresh declaration must be immediately made, giving reasons, and a new period of 6 months will then begin to run. The entry into force of all of these provisions has been deferred to 1 August 2009 (for more details, see Legal Month January-February 2009).

Cross-border mergers

The implementation of the cross-border mergers directive by the Law of 3 July 2008 has been completed by Decree 2008-1116 of 31 October 2008, and Decree 2009-11 of 5 January 2009. Mergers between companies limited by shares are now possible within the European Union, with the necessary majority determined by the national law of the companies concerned. The most suffocating of the restrictions – the requirement of unanimity - has thus been removed. Previously, this requirement had paralyzed such transactions, at least as far as France was concerned. A second step forward relates to the introduction of substantive rules governing the merger agreement and the procedures for approving it. There remain however some restrictive rules imposed by employment law, and in particular the "before and after" principle. This requires the company to put rules of participation in place where the shareholders of one or more of the merged companies had previously had the right to participate in management. This participation, moreover, is not to be understood in a financial sense but as relating to control of the company. In concrete terms, it translates into the election of employees' representatives to the Board.

The new procedure has the merit of not being limited to very large businesses. It can be used by SMEs wishing to group together, or wishing to change the location of their head office and move within the European Union. The cross-border merger procedure is incontestably less cumbersome than the procedure for creation of a SE, which would be an alternative method of changing head office location.

In brief

Judgment of the Commercial Division of the Court of Cassation, dated 29 January 2008: a liabilities warranty may be enforced without proof of damage.

In a judgment of 29 January 2008, the Court of Cassation has held that "the enforcement of a liabilities warranty is in no way subject to proof of financial loss, except where the parties intend otherwise". The Court therefore seems to consider that a liabilities warranty is not a matter of compensation but is a free-standing guarantee, which is more favourable to the beneficiary. This said, the fact that no loss need be shown raises issues over the quantum of damages to be awarded to the transferee.

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- Finance packages (operations with company funds, MBOs and MBIs)
- Investment capital
- Legal auditing
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- IPOs
- Law of securities and financial markets

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