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Europe wide

New Market Abuse Regulation recently endorsed by European Parliament - implications for M&A transactions in Europe

1. European Parliament endorses new Market Abuse Regulation

The European Parliament endorsed in principle the Market Abuse Regulation ("**MAR**") on 10 September 2013. The MAR, which is aimed at combatting insider dealing and market manipulation across European securities markets, will replace the existing European directive on market abuse (Directive 2003/6/EC) ("**MAD**").

Unlike the MAD which had to be implemented into national law by each member state, the MAR will automatically apply in all member states without requiring further implementing legislation. The MAR is expected to come into force around late 2015 or early 2016. It is possible that there will be further changes to the MAR before it comes into force although we are not currently expecting material changes to the matters discussed below.

2. Impact on European M&A Transactions

The MAR contains certain changes or nuances to the existing market abuse rules that will be relevant in member states in the context of M&A transactions.

2.1. Definition of inside information: MAR creates uncertainty by suggesting that a significant effect on price may not required for information to be regarded as inside information

Certain new provisions of the MAR create uncertainty by appearing to provide that price sensitivity may not be necessary for information to be regarded as inside information. Specifically, the MAR contains provisions which provide that information that a "reasonable investor would be likely to use as part of the basis of his investment decisions" is to be regarded as information likely to have a significant effect on price. If this turns out to be the interpretation favored by regulators and courts[1], these new provisions will potentially expand the meaning of inside information in some member states. It is hoped however that, reading MAR as a whole, regulators and courts will continue to regard price sensitivity as a pre-requisite to information being regarded as inside information.

[1] That is, that price sensitivity is not a pre-condition to information being inside information.

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2.2. Facilitation of stakebuilding: MAR provides that a prospective bidder's knowledge of its own intentions is not, in itself, inside information

There has been a concern in some member states that market abuse regulations could be contravened in circumstances where a bidder in a public M&A transaction, who by definition will have knowledge of its own intention to subsequently bid, acquires shares on the market prior to announcement of the bid.

The MAR addresses this concern by providing that the mere fact that a person uses their own knowledge with respect to their prospective bid shall not in itself constitute the use of inside information. The MAR does however go on to provide that a breach of the market abuse regime can occur in circumstances where there is an "illegitimate reason" behind the transaction. No further information is given as to what constitutes an "illegitimate purpose". We believe however that a stakebuilding transaction comprising the acquisition of shares which is effected for the purpose of facilitating the bid (as opposed to, for example, a derivative transaction which is effected for the purposes of giving the bidder exposure to an increase in the share price of the target) is unlikely to be regarded as "illegitimate".

2.3. Facilitating diligence: MAR provides specific exemption to use of diligence information in connection with a public M&A transaction

There has been a concern in some member states that market abuse regulations could be contravened in circumstances where a bidder in a public M&A transaction has access to non-public diligence information from the target company and uses that information in connection with its decision to bid.

The MAR addresses this concern by providing that the use of diligence information by a bidder in a public M&A transaction solely for the purpose of proceeding with that bid will not constitute market abuse if, at the point of approval /acceptance of the bid, any inside information which has been used by the bidder has been "cleansed" (i.e. made public) or has otherwise ceased to be inside information.

The MAR expressly provides however that it remains the case that stakebuilding prior to launch of a public M&A transaction based on diligence information received from target company is capable of constituting market abuse.

2.4. MAR expressly provides that "intermediate steps" leading to a transaction could be viewed as amounting to inside information

Under the existing European disclosure rules, a listed company is required to notify the market as soon as possible of all inside information in its possession. However, delayed disclosure may be permitted under certain circumstances where (amongst other things) the disclosure may prejudice the legitimate interests of the listed company.

Under the existing regime, it was thought that information relating to the intermediate stages of a transaction, particularly the early stages of an M&A transaction where the key terms were still to be agreed, was potentially (in the right circumstances) insufficiently specific or precise to constitute inside information.

The MAR however expressly contemplates that where information concerns a process which occurs in stages (such as an M&A transaction), each stage of the process, as well as the overall process, may constitute inside information. The MAR also expressly provides that such inside information may relate, for example, to the state of contract negotiations or terms provisionally agreed in contract negotiations.

These provisions will create ambiguity. In practice, when the MAR becomes effective, listed companies involved in M&A transactions will need to carefully consider at each stage of a potential transaction (including even the very early stages), whether information relating to the transaction constitutes inside information and if it does, immediately draw up insider lists, put in place close period restrictions and carefully consider whether the requirements for delayed disclosure of that information are met.

2.5. MAR creates an express exemption for market soundings in connection with M&A transactions

The MAR creates an express exemption for market soundings in connection with M&A transactions provided certain conditions are met. These conditions include that:

- the information disclosed is needed to enable the disclosee to form an opinion whether to offer their securities; and
- the willingness of the disclosee to offer their securities is reasonably required for the decision to make the bid.

In many member states market soundings of this type would not likely breach the existing market abuse regime but these provisions are helpful in that they expressly recognize the legitimacy of such soundings.

2.6. MAR implies that dealing between persons holding the same inside information will normally not be considered market abuse

There has been a concern in some member states that market abuse regulations could be contravened in circumstances where the parties to a transaction were in possession of the same information. A classic example of this would be the situation where a prospective investor in a new issue by a listed target company has access to due diligence materials provided by the target company and subsequently invests in the new issue made by the target company.

The MAR appears to implicitly address this concern. Specifically, the MAR provides that market abuse based on insider trading essentially consists of an unfair advantage of inside information to the detriment of third parties who are unaware of it. This implies that market abuse will not normally be committed by parties to a transaction who have the same information.

2.7. MAR creates obligation to inform regulator of decision to delay disclosure of inside information

As mentioned above, under the existing European disclosure rules delayed disclosure of inside information may be permitted under certain circumstances where (amongst other things) the disclosure may prejudice the legitimate interests of the listed company. There is generally currently no obligation in the member states (subject to some exceptions) for a listed company to inform the regulator that it is relying on the exemption to delay disclosure of inside information.

The MAR may change this position. Under the MAR, a listed company must inform the relevant regulator that it has delayed disclosure of inside information at the time the information is disclosed to the public (i.e. the disclosure to the regulator of the fact of the delayed disclosure of information is ex post facto) and provide the regulator at the same time with an explanation of how the conditions for delayed disclosure were met. The MAR does however provide that national law may provide that a record of such explanation be submitted only on request of the competent authority: given the administrative burdens that this requirement to notify would impose, it is hoped that national legislators adopt this partial opt out.

Germany

German Federal Court of Justice Facilitates Downlisting and Delisting

Previous jurisprudence by the German Federal Court of Justice (*BGH*) established significant obstacles for downlisting and delisting which have been eliminated by a recent BGH ruling.

Requirements of Shareholders' Approval and Compensatory Offer Eliminated

In a case where the management board had voluntarily initiated the downlisting of the company from the regulated market of the Berlin stock exchange to the open market of the Frankfurt stock exchange, the BGH ruled that the downlisting of a German stock corporation no longer requires an approval from the shareholders' meeting and a compensatory offer to minority shareholders, the offer amount of which was to be reviewed in appraisal proceedings. The reasoning behind the decision is that the law protects the corporate and financial participation by a shareholder and his or her organizational rights, but does not warrant the market liquidity associated with a listing in general, or with a listing in a specific market segment of a stock exchange. Although the case involved a downlisting, the same principles should also apply to full delistings, as the BGH did not differentiate in its reasoning between a downlisting and a full delisting.

The BGH rendered its new decision also on the basis of a recent ruling of the German Constitutional Court that had held that neither a shareholders' meeting nor a compensatory offer were required to protect the shareholders' rights under the German constitution in the event of a delisting or downlisting.

Remaining Limitations on Downlisting and Delisting

However, minority shareholders are still protected, to a certain extent, under the German Stock Exchange Act which stipulates that shareholders must not be unduly disadvantaged by delisting their shares. In furtherance to this rule, the exchange regulations adopted by various German stock exchanges, including the Frankfurt stock exchange, provide that the effectiveness of the delisting from the regulated market be delayed for a period of up to six months unless the stock corporation or its majority shareholder offers to acquire the minority shareholders' shares against monetary compensation. The rationale for this provision is to provide for a period of time in which shareholders can

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divest their shares via the stock exchange. To the extent the time periods granted are in line with the applicable rules, the respective stock exchange cannot require the offer of monetary compensation and the delisting will have to be implemented upon expiration of the six months' period in any event.

Outlook

The decision establishes clear rules and paves the way for German stock corporations to delist, thereby saving the costs associated with providing ongoing disclosure. Moreover, the new jurisprudence may allow a majority shareholder whose shareholdings are just short of, e.g., the squeeze-out threshold to convince outstanding minority shareholders to sell their shares by announcing a delisting. Potential adverse effects of an outright full delisting on the liquidity of the minority shareholders' shares may be mitigated by employing a two-step strategy: Such a strategy could include the implementation of a downlisting from a regulated market to an open market for an interim period as a first step, and an eventual full delisting from the open market as a second step. Delisting from an open market is less cumbersome and can be achieved in case of, e.g., the Entry Standard of the Frankfurt stock exchange by giving six weeks' notice.

However, in order not to breach its duties, the management board still needs to carefully assess the consequences of a delisting for the stock corporation under the business judgment rule.

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Germany

Tougher Legislation on Remuneration of Management Board Members expected after Failure to clear through German Parliament

After the failure of draft legislation aimed at restricting excessive executive pay two days before the parliamentary elections in Germany, the new German government is determined to launch a second run. Thus, the so-called "Law on improving Control over the Payment of Remuneration to Management Board Members and on amending further Stock Corporation Act Provisions" (*Gesetz zur Verbesserung der Kontrolle der Vorstandsvergütung und zur Änderung weiterer aktienrechtlicher Vorschriften*, "VorstKoG", the "**Draft**") could develop an active afterlife.

The Draft

The Draft was designed to toughen provisions on the remuneration of members of the management board (*Vorstandsmitglieder*) of a (listed) German stock corporation (*Aktiengesellschaft*) in response to recent public debate on excessive executive pay. The core proposal of the Draft would have introduced a 'say on pay' mechanism under which the supervisory board (*Aufsichtsrat*) of a listed stock corporation would have been required to submit annually the proposed remuneration system, including the maximum obtainable level of remuneration, to the general meeting for (binding) shareholder approval. This would have resulted in a new and hitherto unknown degree of shareholder say on executive remuneration in Germany.

In addition, the Draft included amendments to the Stock Corporation Act (*Aktiengesetz*, the "**SCA**") going beyond remuneration issues such as limiting the unrestricted availability of bearer shares to listed stock corporations or requiring stock corporations that have issued registered shares to maintain a share register regardless of whether or not share certificates are issued. It would also have addressed a number of other important areas, e.g. acknowledged the legitimacy of mandatory convertible bonds, and in particular would have allowed for the creation of conditional capital beyond the current maximum of 50% of the subscribed capital under certain circumstances (in particular to respond to a corporation's over-indebtedness or imminent insolvency) and allowed for the creation of preferred shares without voting rights where the unpaid amounts do not accrue.

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The Upper House of the German Parliament (*Bundesrat*), dominated by the Social Democrat Party and the Green Party, objected to the Draft as it allegedly fell short of expectations regarding the executive pay problem, although the other amendments to the SCA suggested in the Draft were seemingly uncontroversial and would have clarified a number of important practical questions.

Outlook

The Social Democrats now form part of the new German government, which is determined to introduce a binding shareholder vote on executive pay. However, the Draft's failure in the previous period of government means that a re-draft has to pass once again through the entire legislative process. It seems likely that the government will draw on the experiences made with the failed Draft and there is hope that any re-draft will include the long awaited and less disputed changes to the SCA. As such new draft legislation would be supported by all major German parties, its prospects of success would be significantly higher than prior to the elections.

In the meanwhile, the global public debate on excessive executive pay thrives. The EU Commission is in preparations to initiate rules which could go beyond the plans of the German government. In particular, shareholders could be granted the right to determine the ratio of executives-to-employees pay.

Germany

Introduction of Corporate Criminal Liability in Germany?

The state of North-Rhine-Westphalia plans to initiate a legislative proposal for a Corporate Criminal Liability Act (*Verbandsstrafgesetzbuch*, the "**Draft**") that would, for the first time in German history, allow for criminal liability of corporations. The Draft is currently being discussed and coordinated between various state Ministries of Justice. Subsequently, it could be formally introduced as a legislative proposal by the Upper House of the German Parliament (*Bundesrat*). It is noteworthy in this connection that the newly elected German government included the consideration of criminal liability for multinational corporate groups as a goal in their coalition agreement.

Currently no Corporate Criminal Liability in Germany

Currently, only individuals can commit crimes under German law. Corporations are only liable under the Administrative Offense Act (*OWiG*) for (i) administrative offenses and crimes committed by their high ranking officers and (ii) administrative offenses and crimes committed by their other employees and which could have been prevented by proper oversight mechanisms.

Administrative fines (but no criminal sanctions) of up to EUR 10 million can be imposed on a corporation. A fine may exceed these limits if necessary to seize the entire economic advantage obtained by the corporation due to the actions of its officers and employees but further sanctions (such as turnover-based fines or protection periods) are unavailable and material fines are rarely imposed so that the fines are often not a substantial determent.

The Draft

The Draft now imposes criminal liability on a corporation if crimes are committed that (i) refer to legal duties of the accused corporation or (ii) that the accused corporation benefits from. These crimes under the Draft would be attributed to the accused corporation if they have been committed by (i) such corporation's high ranking officers or (ii) anybody acting in the interest of such corporation and who has not been sufficiently supervised by such corporation's ranking officers ("organized irresponsibility").

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The Draft would be applicable to both German and foreign corporations for crimes committed, *inter alia*, (i) within Germany, (ii) against Germans abroad (under certain conditions), (iii) by German corporations abroad or (iv) under international criminal law.

The key news of the Draft are on the sanctions side: Other than under current law, a corporation can now face “true” criminal sanctions. In particular, it can be (i) fined in an amount up to 10% of its annual turnover (taking into account the global turnover of all individuals and corporations operating as one entity with the accused corporation, e.g., all members of the holding structure that it forms part of), (ii) issued a warning without punishment that imposes both a probation period and certain conditions on future conduct, (iii) publicly denounced through a publication of the judgment, (iv) excluded from public subsidies, (v) excluded from public procurement, (vi) dissolved if possible under German law (thus, a dissolution would not seem to be applicable to foreign entities). If the Draft is enacted, corporations will face highly increased compliance risks in Germany.

A criminal sanction may be avoided if a corporation helps in the discovery process and through sufficient organizational and personnel measures excludes the possibility of a repetition of the crime.

UK

Important developments in the interpretation of MAC clauses in English law

Material adverse change (MAC) clauses in English law acquisition agreements are typically drafted in general (and some would say vague) terms. Many would say this is for good reason – to get deals done.

Given the generality of the typical definition, it is not surprising that MAC clauses are potentially capable of a number of different interpretations in the event of a dispute. The uncertainty created by the generality of the definition of MACs is exacerbated by (until recently) a dearth of reasoned consideration of MAC clauses by the English courts.

MAC clauses in US law acquisition agreements

There have however been a number of judicial decisions in the United States in relation to MAC clauses in acquisition agreements particularly in the Delaware courts.

The decisions of the US courts indicate that it is very difficult for a buyer to trigger a MAC clause in an acquisition agreement. A Delaware court even indicated in 2008 it was not aware of any Delaware court having allowed a buyer to do so[1].

One of the landmark US decisions (which has been followed in a number of recent US cases) is *IBP v Tyson Foods*[2]. In that decision, the court considered whether a MAC clause in a merger agreement had been triggered.

The court found the words of the MAC clause (which was drafted in typically general terms) were not decisive of the issue – the "*simplicity of ..[the] words is deceptive, because the application of those words is dauntingly complex*". The court therefore concluded that:

> *"the resolution of the parties' arguments turns on a difficult policy question. In what direction does the burden of this sort of uncertainty fall: on an acquirer or a seller?"*

The "*factual context in which the parties were contracting*", the "*commercial setting within which the parties were operating*" and "*negotiating realities*" lead the court to determine that a MAC clause in an acquisition agreement needed to be construed from a "*seller friendly perspective*".

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1 *Hexion Specialty Chemicals v Huntsman Corp*, 965 A.2d 715

2 *In re IBP, Inc Shareholders litigation*, 789 A.2d 14.

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The Grupo Hotelero case

In the recent case of *Grupo Hotelero*[3], we were given some important clues to the way in which English courts are likely to approach the interpretation of MAC clauses including in acquisition agreements.

In *Grupo Hotelero*, the High Court considered the application of a MAC clause in a loan agreement. Specifically, the court held that:

- an adverse change will be material if it significantly affects the borrower's ability to repay the loan in question;
- the lender was not entitled to trigger the MAC clause on the basis of circumstances of which it was aware at the time of the agreement;
- in order to be material, a change must not be merely temporary; and
- the lender bore the burden of proving the MAC was triggered.

Although this decision related to the interpretation of a MAC clause in a loan agreement, it is notable that the above principles are very similar to the principles which the US courts have developed in considering the application of MAC clauses in acquisition agreements. Additionally, the court appeared to specifically endorse some of the key principles of the landmark US decision of *IBP v Tyson Foods* decision referred to above. In particular, the court appeared to quote with approval the statement of the court in *IBP v Tyson Foods* to the effect that MAC clauses (in acquisition agreements) are:

> *"….best read as a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner."*

Where does this leave MAC clauses in English law governed acquisition agreements?

There remains a lack of detailed consideration of MAC clauses by the English courts. However, the *Grupo Hotelero* case, even though it related to the application of a MAC clause in a loan agreement, strongly suggests that the principles developed in the US cases are likely to play an important role in the consideration of MAC clauses in acquisition agreements by English courts.

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3 *Grupo Hotelero v Carey Value Added* [2013] EWHC 1039.

In absence of specific language suggesting otherwise in the MAC itself, those principles developed by the US courts (some of which were endorsed in the *Grupo Hotelero* decision) are likely to include the following:

1. The buyer bears a burden of proof of showing that a MAC has been triggered must and must invoke a strong showing to do so.

2. To trigger a MAC clause, a buyer will need to demonstrate an event which substantially threatens the overall financial condition of the target. There is normally no specific threshold which is applied to determine whether or not the effect is "substantial" although the case law suggests it should be an event which undermines the purpose of the transaction (which in the case of a leveraged transaction, could include the ability to repay financing incurred in connection with the acquisition).

3. To trigger a MAC clause, a buyer will need to demonstrate an event which affects the target business in a durationally significant manner. A durationally significant effect is likely to be measured in years rather than months. The implication is that a buyer will need to demonstrate a continuing adverse impact "which is expected to persist significantly into the future"[4].

4. A MAC clause is not likely to protect a buyer against known (or potentially foreseeable) matters. The implication is that the buyer is "on risk" for matters of which it was aware and potentially for matters which were the foreseeable consequence of those matters.

[4] *Hexion* at page 39

UK

High court implies a duty of good faith into long term relational agreement governed by English law

English law has not traditionally recognized a doctrine of good faith in respect of the performance of contractual obligations.

The High Court has recently ruled[1] that, although English law was not yet at the stage where it was ready to recognize a general requirement of good faith in relation to all contracts, it may be implied into particular contracts depending on the circumstances. Specifically, the High Court suggested that a duty of good faith may be implicit in long term relational contracts such as joint venture agreements, franchise agreements and long-term distribution agreements. The High Court emphasized that the nature of the implied term, and the conduct required to discharge the implied obligations, were likely to be fact specific but did highlight three obligations which it believed were commonly implicit in longer-term relational contracts:

- honesty;
- fidelity to the spirit of the agreement; and
- observance of standards of commercial fair dealing.

It remains to be seen whether the principles developed in this case will be affirmed or applied in subsequent cases. In any event, in the absence of specific language to the contrary, in our view it would now be prudent to assume that duties of good faith are likely to arise in the performance of longer term relational contracts (such as shareholder or joint venture agreements) governed by English law.

[1] *Yam Seng Pte Limited v International Trade Corporation Limited* [2013] EWHC 111

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