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Shareholder Activism in Germany Following Takeover Announcements

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Over the past few years there has been a noticeable increase in the frequency of activist investors building up considerable stakes in German listed companies in the context of public takeovers. One reason for this development is what appears to be a new business model of hedge funds – the realization of profits through litigation after the completion of a takeover. To this end, the funds take advantage of minority shareholder rights granted under German stock corporation law in connection with certain corporate measures which are likely to be implemented for business integration purposes following a successful takeover.

One prominent example of this strategy was the filing of various lawsuits by hedge funds against UniCredit and its management in the aftermath of UniCredit's acquisition of HypoVereinsbank in 2005 and the subsequent "squeezing-out" of HypoVereinsbank's remaining minority shareholders in 2007. More recent cases include the takeover offer by Terex for Demag Cranes (2011), by Vodafone for Kabel Deutschland (2013) and, of late, by McKesson for Celesio (2013), where Paul E. Singer's hedge fund Elliott Management each time acquired substantial shares in the German target.

Companies seeking to acquire control of German listed companies need to be aware of the risks and costs potentially associated with activist stake building in takeover situations before making an investment decision. Below we outline the legal framework for activist funds in post-takeover situations as well as their strategic behavior during the takeover and following its completion. Subsequently, we provide some general guidance to companies considering a public takeover offer in Germany.

POST-TAKEOVER BUSINESS INTEGRATION AND CORPORATE MEASURES

Following successful completion of the takeover, the buyer will typically wish to integrate the target's business in order to realize synergies. A commonly used means in this regard is the conclusion of a so-called domination and profit and loss transfer agreement ("**DPLTA**") which enables the buyer to control the target's strategy and business decisions and to access its cash flow. Entering into a DPLTA is possible under German stock corporation law if the buyer holds at least 75% of the share capital.

Ultimately, a strategic investor may seek to own the target company in its entirety, i.e. 100% of its shares. In this respect, German law offers a variety of so-called "squeeze-out" procedures by means of which a principal shareholder owning at least 90% or 95% of the share capital (depending on the procedure chosen) can force a transfer of the remaining shares held by minority shareholders to the principal shareholder.

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MINORITY SHAREHOLDER RIGHTS

Pursuant to the German Stock Corporation Act (*Aktiengesetz*), a DPLTA must include the obligation on the part of the dominating company to acquire the shares of the minority shareholders of the dominated company in return for appropriate consideration, typically in cash, if so requested by such shareholders. Minority shareholders have the right to challenge the appropriateness of the consideration for their shares by means of court proceedings pursuant to the German Act on Legal Challenge Proceedings (*Spruchverfahrensgesetz*).

Similar minority protection rights apply to shareholders whose shares are transferred by virtue of squeeze-out measures as described above.

ACTIVIST STRATEGY AND LITIGATION

Recent history has a series of examples of hedge funds equipped with large financial resources taking advantage of minority shareholder rights associated with corporate measures implemented after successful takeovers.

The typical fund strategy can be outlined as follows: Once a public tender offer has been announced, the funds, within a short period of time, acquire substantial stakes in the target companies, usually ranging somewhere above 10% of the target's share capital. However, the funds do not do so with the aim of blocking the takeover or otherwise hindering its success. To the contrary, they would tender a portion of their shares into the offer in order to help it succeed, if, for example, the takeover offer is made conditional upon the crossing of a minimum acceptance threshold. Such a minimum acceptance threshold typically equals 75% of the outstanding shares, which is the qualified majority under German stock corporation law necessary to implement certain corporate structural measures such as DPLTAs.

After completion of the takeover, the funds will wait for a DPLTA to be concluded which, as mentioned above, must include the obligation to acquire the shares of minority shareholders in return for appropriate consideration. The activists will then commence court proceedings challenging the appropriateness of the consideration in an effort to achieve a higher price for their shares. In the past, hedge funds have been notably successful in such proceedings, not infrequently obtaining a considerable premium on the consideration for their shares.

GENERAL RECOMMENDATIONS

While it is impossible to make generally applicable recommendations, as any advice needs to be adapted to the specific circumstances of the contemplated takeover, we provide below some considerations that may serve as preliminary guidance to foreign investors envisaging a strategic takeover of a German listed company.

The fund strategy described above is essentially based on statutory shareholder rights under German law. Hence, while there may be ways to mitigate, at least to some degree, the risks and costs associated therewith, such behavior by shareholders can generally not be precluded. Therefore, any foreign investor that considers making a public takeover offer for a German target should anticipate activists getting involved during the takeover process, leading, potentially, to an increase in the costs of the transaction in the form of a higher purchase price to be paid for a portion of the outstanding share capital.

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Taking a closer look at the shareholder structure of the target company prior to an investment decision is certainly worthwhile – the higher the free float of a company and the more fragmented its shareholder structure, the easier it will normally be for a fund to acquire a large stake via the stock exchange within a short period of time following the announcement of a tender offer.

According to German case law, the consideration to be offered for outstanding shares on the occasion of certain corporate structural measures is calculated taking into account the average weighted stock price for a period of time preceding the announcement of such corporate measures. Therefore, the timing of a corporate measure and its announcement, respectively, are issues to be considered when structuring the timetable of a public takeover and subsequent corporate integration steps.

Finally, once court proceedings have been initiated in an effort to challenge the appropriateness of the consideration offered to external shareholders for their shares, experienced legal counsel is crucial in order to effectively counter allegations made by the activists in court.

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