



Focus on Private Equity

Proposed EU Merger Review of Non-Controlling Minority Shareholding Acquisitions: Challenges and Opportunities for Private Equity

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At present, the EU Merger Regulation [Council Regulation (EC) No 139/2004] (the Merger Regulation) gives the European Commission (the Commission) jurisdiction to review transactions that lead to a change in control. However, a recently proposed plan to reform the Merger Regulation could expand the scope of transactions subject to prior notification. For the first time, minority shareholding acquisitions that do not lead to a change in control could be subject to prior notification to the Commission.

The proposed expansion of the Merger Regulation's jurisdiction could significantly impact businesses, in particular private equity firms. Understanding the proposed reforms is critical to meaningful participation in the policy debate and to determining how best to manage the challenges it presents.

Why Amend the EU Merger Regulation?

The Commission has an extensive "tool kit" to regulate anticompetitive conduct. Its tools include the Merger Regulation, which enable the *ex ante* review of transactions that result in a "change of control". (Transactions must meet specific jurisdictional thresholds based on the parties' worldwide and Community turnover.) Other tools include Articles 101 and 102 of the Treaty on the Functioning of the

European Union (TFEU), which prohibit anticompetitive agreements and the abuse of a dominant position, respectively.

There are no specific tools designed for the review of non-controlling minority shareholding acquisitions, but the Commission is not without options to regulate them. The Court of Justice of the European Union confirmed that the Commission can use Articles 101 and/or 102 TFEU to review minority shareholding acquisitions, but these tools have rarely been used. (See Case 142 and 156/84 *British-American Tobacco Company Ltd. and R.J. Reynolds Industries Inc. v. EC of the European Communities*, [1986] ECR 1899.) The Commission can also review minority stakes already held by parties to transactions that require notification under the Merger Regulation concerning a separate acquisition of control, and in some cases has required the divestment of a pre-existing minority stake as a condition for clearing the separately notified transaction. (See Case M. 3653 Siemens/VA Tech (July 13, 2005); See also Case M. 3696 E.ON/MOL (December, 21 2005).)

Despite its available tools, the Commission has expressed concern that its inability to review *ex ante* non-controlling minority shareholding acquisitions has created an "enforcement gap." Following a public consultation in 2013, the Commission concluded that it required additional tools to enable it to regulate *ex ante* non-controlling minority shareholding acquisitions. This led to the current proposed reforms to the Merger Regulation.

Proposed Amendments: Attempting to Close the Enforcement Gap

The current proposed reforms are detailed in a white paper issued on July 9, 2014, which covers non-controlling minority shareholding acquisitions and other proposed refinements to the Merger Regulation. A white paper is typically a blueprint for future legislative reform.

With respect to non-controlling minority shareholding transactions, the white paper intends to subject only those transactions that create a “competitively significant link” to advance notification. These are defined as minority shareholdings in direct competitors or vertically-related companies where the parties meet certain revenue thresholds and the acquired stake is:

- Approximately 20 percent or
- Between 5–20 percent, if it is combined with additional factors, such as a *de facto* blocking majority, a seat on the board of directors or access to the target’s commercially sensitive information

The combination of a shareholding and “plus” factors is similar to the approach taken in the EU Member States that review non-controlling minority shareholding acquisitions, including Germany, the United Kingdom and Austria, but the Commission’s proposal has a broader reach.

Under the Commission’s proposal, parties to a transaction resulting in a “competitively significant link” would be required to submit an information notice to the Commission. This submission would be made public in order to alert third parties to the proposed transaction. The parties would then be subject to a waiting period of 15 working days, during which they would not be able to close their transaction. The Commission would use that initial period to decide whether to challenge the transaction, and the EU Member States could decide whether to seek a referral to review the transaction themselves.

If the Commission decides to investigate the transaction during the initial 15 working days, the parties would be obliged to file a full, detailed merger notification, which would be followed by a waiting period during which the transaction could not be closed. In any event, after the first 15 working days, the

Commission would retain the right to initiate a review of the transaction during a subsequent period of 4 to 6 months, regardless of whether the parties closed the transaction. The Commission has not yet specified the procedural details that will apply to investigations commenced during the four to six month period. However, the Commission has suggested that it could impose a “stand-still” obligation for any part of the transaction that has not been closed to ensure the effectiveness of the Commission’s ultimate decision under the Merger Regulation.

Challenges and Opportunities for Private Equity

Private equity firms are already subject to advance notification and approval of certain non-controlling minority shareholding transactions in certain European jurisdictions (Germany, Austria and the United Kingdom) and worldwide (e.g., the United States and Japan). For example, in the United States, the acquisition of voting securities valued at more than \$75.9 million (adjusted annually) may need to be notified to the antitrust authorities, even if there is no change of control (which is defined narrowly under the relevant rules). This means that all transactions above this threshold may be subject to antitrust review, regardless of the level of influence the buyer acquires. A narrow safe harbour, however, exempts the acquisition of up to 10 percent of a target’s shares from antitrust review if the shares are held passively for investment purposes.

The Commission’s proposal, however, reaches acquisitions as small as 5 percent, and thus has a potentially broader reach than other jurisdictions that review minority shareholding acquisitions. This creates challenges that may particularly impact private equity firms—and, correspondingly, may create risks that beneficial investments will be foregone.

First, private equity firms are more likely to be impacted than others by the Commission’s proposed reforms because their business models more often involve non-controlling, strategic acquisitions. Although the Commission’s proposal involves a “lighter” information notice than for acquisitions of controlling shareholdings, it still requires information and analysis of the markets at issue and, therefore, may involve additional costs. The increased transactional costs of a minor investment may make the investment less attractive for private equity.

Second, the Commission's proposal also entails a mandatory 15-day waiting period and publication of the transaction. Private equity firms often rely on confidentiality prior to closing a transaction in order to gain a competitive advantage. The potential for premature disclosure, combined with a waiting period of 15 working days during which the transaction could not be closed, could place this competitive advantage at risk.

In addition, even after expiry of the initial 15 working days, there would still be a 4 to 6 month period during which the Commission would be able to launch an investigation into the acquisition of the non-controlling minority acquisition and order that the incomplete steps of the transaction be suspended in the meantime. This could have the effect of deterring investors—especially if they are looking for legal certainty—because, even if they close their transaction, they will still have to wait four to six months until they know definitively whether the Commission will or will not investigate the transaction.

These challenges show that private equity firms have much at stake in this reform. However, awareness of these challenges creates opportunities as well. Notably, an appropriately tailored voluntary notification system with a reasonable, limited review period could enable private equity firms to obtain greater legal certainty for their non-controlling minority shareholding acquisitions. Such a system could thus promote productive and efficient investment. Yet, at the present time, the proposed reforms, as currently structured, could actually decrease legal certainty.

Nevertheless, the proposed reforms remain in an early stage, as of the date of this article, and it may be several months before they take concrete shape. This provides an opportunity for private equity firms to engage in the regulatory and political process, in which they can advocate reforms that create greater legal certainty without introducing procedures likely to deter investment.

For example, a better outcome for private equity firms could still be realized through the reform process, in particular through the resolution of issues surrounding the proposed reforms' broad jurisdictional reach, the notification process, confidentiality and the open-ended review period after the first 15 working days. By working with the Commission and engaging in the subsequent political debate, it is still possible

to both serve the Commission's objective of closing the enforcement gap, while not chilling productive investment.

Conclusion

Ultimately, the proposed reforms to the Merger Regulation concerning non-controlling minority shareholding acquisitions are likely to create additional—and generally unwelcome—burdens for private equity firms, and may well discourage beneficial investment in Europe from some of the most active investors. This would be an unfortunate consequence of reforms designed ultimately to catch only a very narrow category of non-controlling minority shareholding acquisitions. Private equity firms need to engage in the legislative process to ensure that the reforms ultimately adopted are structured in a way to guarantee legal certainty and encourage investment.

IPO Market Offers Attractive Exit Alternative for Sponsor-backed Companies

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Since 2012, the U.S. initial public offering (IPO) market has once again offered a robust option for private equity sponsors seeking to exit portfolio company investments. There were more than 100 IPOs of sponsor-backed companies in 2013, and 2014 is on track to match that total.

A viable IPO market allows a sponsor to conduct a “dual-track” process by pursuing an IPO, while at the same time conducting a private auction to sell the portfolio company. Many sponsors believe that the existence of the IPO alternative serves as an incentive for potential buyers in the auction to move more quickly and bid up the price. When an IPO is viewed as the preferred option, such as when the sponsor believes that the company is being undervalued by potential buyers or the sponsor otherwise wishes to benefit from the company's future growth in the public markets, the dual-track process allows the sponsor to protect itself from the fickleness of the public markets by keeping the sale option on the table.

While an IPO offers the potential for greater returns in the long-term than a sale, sponsors must carefully manage the

dual-track process and make sure the proper structure is in place in order to be in the position to obtain the maximum benefit from an IPO.

Managing the Dual-track Process

One of the historical considerations that companies have had in pursuing IPOs as part of a dual-track process is that they were required to publicly file their registration statements, including sensitive financial information, at the outset of the process when the ultimate success of the offering is uncertain. The recently enacted Jumpstart Our Business Startups Act (the JOBS Act) has made the dual-track process more attractive. Under the JOBS Act, companies that qualify as emerging growth companies (EGCs) may confidentially submit their registration statements for review by the staff of the Securities and Exchange Commission (SEC) and maintain that confidentiality until just 21 days before they launch the offering. While a sponsor-backed company conducting a dual-track process may still consider making a public announcement of the submission of the registration statement so that the broadest set of potential buyers in the concurrent sale process are made aware of the IPO alternative, the contents of the registration statement can remain out of the public eye until the company decides to choose the IPO path.

In addition, the JOBS Act allows EGCs to test the waters for their potential IPOs by engaging in oral or written communications with qualified institutional buyers (QIBs) and other institutional accredited investors before or after the initial filing of a registration statement in order to gauge investor interest in a proposed offering. Before the JOBS Act, oral communications with potential investors prior to the filing of a registration statement and written communications other than the prospectus, even after the filing of a registration statement, could have been considered impermissible “gun jumping.” In the context of a dual-track process, this meant waiting until late in the IPO process to commence the sale process. With the ability to test the waters, EGCs can begin the sale process at an earlier stage.

Putting the Proper Structure in Place

When structuring their investments in companies that are going public, sponsors must strike a balance between maintaining controls that will allow them to continue to make or

influence certain decisions of the company following the IPO against the potential that a company with such controls in place may be perceived by the non-controlling stockholders as having less value to them, resulting in underperformance of the stock in the market.

When a sponsor or group of sponsors will continue to own more than 50 percent of the company’s stock following the IPO, the most basic question is whether the company will take advantage of the controlled company rules of the stock exchanges, which provide an exception to the general requirement that a majority of the board and certain board committees be independent (although the audit committee of the board will still need to be comprised of at least three independent directors). Unsurprisingly, Institutional Shareholder Services and other investor advocates disfavor controlled companies, especially if the control results from a dual-class stock structure. Nevertheless, sponsors often take advantage of the controlled company exemptions under stock exchange rules. When controlled company status is conferred by virtue of a group of sponsors banding together in a club deal to vote for each other’s director nominees, the sponsors likely will be considered a “group” under SEC rules, resulting in increased reporting obligations and restrictions.

Sponsors who seek to maintain a representative on the board of directors without entering into a voting agreement and triggering group status may, instead, put in place a three-class staggered board, with the sponsor-nominated directors in the class expiring at the third meeting following the IPO. This would at least ensure that these directors would remain on the board for the initial three-year period.

Sponsors may also wish to continue to have certain control rights, such as the ability to nominate board members even if their share ownership dips below a majority, as well as negative covenants requiring their approval over certain corporate decisions. Rights to approve certain corporate decisions are often viewed as important, even if a majority of directors are elected by the sponsor, because the directors have fiduciary duties to all of the company’s shareholders, not just the sponsor, whereas the sponsor generally can act in its own self-interest when exercising veto rights. When such rights stay in place, they often exist until the sponsor’s shareholdings dip below a specified level.

Sponsors also need the ability to liquidate the shares they continue to hold in the portfolio company following the IPO. Registration rights give sponsors the ability to have their shares registered with the SEC for resale following the IPO, so that the sponsor can sell shares in underwritten offerings or in non-underwritten offerings where the amounts to be sold exceed the volume limitations imposed by SEC rules for unregistered sales by company affiliates. In addition, in order to give a sponsor the ability to sell large stock positions, sponsors often have the portfolio company opt out of Section 203 of the Delaware General Corporation Law, which imposes future restrictions on a buyer who acquires 15 percent or more of a company's stock, unless the acquisition is approved by the company's board or stockholders. Sponsors also should consider potentially distributing the shares they hold to their limited partners instead of selling the shares themselves, to the extent permitted by their fund documents. A number of issues are raised by such distributions, which should be carefully considered.

Other continuing rights may include tag-along, drag-along and other rights among a group of large shareholders, which are put in place in order to coordinate orderly exits. These rights may also trigger group status under SEC rules and, therefore, should be structured carefully.

Sponsors also often have the company going public waive the corporate opportunity doctrine so that their director representatives on the board may avoid situations where these directors will have a conflict of interest in deciding whether to allocate a corporate opportunity to the sponsor or the company.

Sponsors should also address any monitoring or similar fee arrangements they have in place with the portfolio company to determine if they continue or are terminated and, if terminated, whether a fee is payable upon termination. These fees have proven controversial recently, with one labor union waging a public battle against payment of such fees to a particular sponsor, and they may have other regulatory consequences.

Tax structuring must be considered carefully as part of the process, including potentially putting in place a tax receivable agreement or implementing a so-called Up-C structure, where appropriate.

The matters discussed above are only some of the issues sponsors must consider when their portfolio companies proceed down the IPO path. While the IPO process is complex and requires close coordination with the company's lawyers and bankers, sponsors will continue to pursue the IPO path for their portfolio companies if they believe that it offers a significantly greater potential return than a sale process.

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