

# Trends in European Mergers and Acquisitions

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**The 2006 first-quarter volume of announced M&A deals in Europe was the highest for that period since 2000. What is fueling the activity and why?**

*Simpson:* Europe has witnessed a boom in cross-border mergers and acquisitions since the beginning of 2006, particularly hostile takeovers. Purchases of European companies reached an unprecedented \$418 billion within the first quarter of the year, compared with purchases of American companies totalling \$211 billion in the same period. Europe has seen large pan-European hostile takeover battles, such as the fierce \$25.6 billion merger of Netherlands-based Mittal Steel with Luxembourg-based Arcelor, the \$26.9 billion takeover of Endesa of Spain contested between E.ON of Germany and Gas Natural of Spain, and the \$14.5 billion takeover by Ferrovial of BAA, and large friendly combinations, such as the \$14.3 billion merger of Autostrade of Italy and Abertis of Spain.

The upsurge in European M&A in the first six months of 2006 was founded primarily on favorable underlying economic conditions. Large European companies restructured their balance sheets substantially after the downturn that followed the March 2000 stock crash, implementing significant operational and financial cost-cuttings, and positioning themselves for growth opportunities as they arose.

*Hatchard:* The cost of capital has been relatively low, and capital has been fairly easy to raise, making it easier for strategic players and private equity funds alike to lever up and offer cash, as opposed to stock, as consideration. In fact, the proportion of cash that was offered in

this merger wave to date marks one of the principal differences between the current takeover boom and the one at the end of the '90s.

*Servan-Schreiber:* Another clear driver has been the need for horizontal cross-border consolidation in Europe, to create a class of pan-European champions able to compete with their counterparts around the globe. The European market continues to be extremely fragmented in a number of industries that have been at the center of the recent increase in merger activity, such as utilities, energy, industrial, and financial services.

*Mayer:* Executives of European "national champions," as well as smaller players, are moving to grow by way of acquisition based on the realization that they need to increase the scale and geographic footprint of the companies they manage if they are to position them to seize growth opportunities in the principal developing economies, particularly the areas collectively known as BRICET [Brazil, Russia, India, China, Eastern Europe, Turkey]. Despite regulatory harmonization lagging behind its planned implementation, the EU single market and single currency have begun to create an environment that is conducive to this much-needed process of European consolidation.

**Many major companies have a lot of cash to use for European acquisitions. From a tax perspective, does that mean structuring the transactions is relatively straightforward?**

*Oosterhuis:* Yes, compared with transactions that must be tax-deferred for target company shareholders. However, in many circumstances, an otherwise straightforward

cash acquisition can be complicated by the need to defer tax for key employees or a major shareholder. These circumstances can typically be accommodated by permitting the shareholder to retain some form of share interest in the target or security issued by the bidder, but have that interest exchangeable into acquir-

ing company shares to provide liquidity. Beyond that, cash acquisitions are real tax planning opportunities. While most European jurisdictions have thin capitalization rules that must be followed, those rules typically permit substantial inter-company borrowing to fund acquisitions. That allows interest expenses to be deducted against the target's income after the acquisition, with interest income accruing in a jurisdiction with a relatively low tax rate. The result can be a lower worldwide tax rate on the target's income after the acquisition.

**Hostile takeovers and unsolicited bids have increased recently in Europe. Why?**

*Simpson:* Concurrent with the increased M&A activity, Europe has also seen an unprecedented rise in hostile takeovers, which was caused by an additional layer of factors. Timing is one of the principal dynamics at play here. Strategic industrial players have seized the window of opportunity opened by stable economic conditions to achieve growth by way of acquisition, which is faster than organic growth. But in order to snatch up opportunities as they arise, beat competition from private equity players, and force consolidation in the face of the reticence of target management, national governments and, at times, national regulators, strategic players have had to resort to aggressive takeover tactics. Changes in the structure of Continental European capital markets in past years have been crucial in laying the ground for this upsurge in hostile takeovers; in the last 10 to 15 years, Europe has seen an increasing number of companies coming to market, and over time, European stock has become more

widely held and increasingly liquid. All of these factors are causing a change in the way European executives and shareholders see hostile takeovers, which is reminiscent of the change in mentality that took place in the U.S. as a result of the wave of hostile M&A activity in the '80s.

### **Is government protectionism still an important issue in cross-border deals in Europe?**

*Servan-Schreiber:* Notwithstanding the increase in hostile activity and the continued harmonization of European laws, national governments seem to find it difficult to abstain from intervening in cross-border takeovers. A few recent examples include the involvement of the French and Luxembourg governments in the early stages of the Mittal Steel-Arcelor merger, of France in the proposed takeover of Suez, of the Spanish government in the takeover of Endesa, and Italy's role in the merger of Autostrade and Abertis. National governments become substantially involved in virtually all high-profile mergers in continental Europe, and, if they are hostile takeovers, national governments are a formidable force to be reckoned with by bidders.

*Simpson:* That said, while in certain circumstances national governments have been able, and will continue, to influence the outcome of takeover battles, their power and appetites are diminishing substantially as European stocks become more widely held and stock market forces drive takeovers to completion. For example, Dutch ABN AMRO's takeover of Italian Banca Popolare Italiana, which was strongly opposed by Italy's government and Italy's central bank, was successfully completed in the first quarter of 2006. It is reasonable to assume that as stock markets continue to expand, market forces and industrial logic will prevail in Europe over national protectionism. But for the moment, certain industries may continue to be insulated by government forces from unsolicited mergers and acquisitions activity.

### **What is the status of takeover regulation in Europe? How do you see this process evolving?**

*Mayer:* Another obstacle to European consolidation through unsolicited takeover offers is the lack of regulatory harmonization. While for the last 15 years, the EU Commission has been trying to create a regulatory infrastructure that would be conducive to consolidation, it has achieved mixed results at best. Certain milestones have been reached: the single currency, the EU prospectus directive, and one accounting standard for all listed companies – IFRS. However, in other areas, largely as a result of member states' lack of political willingness to put national champions up for sale, the EU Commission has not achieved its objectives to establish a uniform takeover code, or uniform set of corporate governance standards, and golden shares and other forms of veiled or blatant national protectionism continue to exist.

### **As hostile takeovers increase, what defensive measures are being taken by targets?**

*Simpson:* The takeover directive, in particular, could have been an opportunity for the EU to establish a uniform takeover code. But the EU Commission's proposal to eliminate the ability to raise takeover defenses in connection with hostile bids – consistent with the approach in the U.K. – was, barring a few exceptions, widely rejected by continental EU member states as too radical a change in approach and would have opened the door to takeovers from outside the EU – especially, as most countries feared, the U.S. As a result, the rules against defensive measures were made optional, and, while the takeover directive has still not been implemented in many of the principal EU economies, most EU countries seem inclined to retain their existing framework with regard to a target company's ability to defend against hostile bids.

*Hatchard:* That said, a trend in continental Europe is emerging with respect to takeover defenses, which is a hybrid between the approach in the U.S. and the U.K. In the U.S., takeover defenses are allowed to a point, as they are subject to market scrutiny and a very sophisticated set of ever-developing rules established through more than 25 years of takeover-related court cases, primarily around the business judgment rule. In the U.K., in order to limit litigation, takeovers are regulated by a takeover code, supervised by a sophisticated regulator – the Takeover Panel – and takeover defenses are generally not allowed, beyond a merits-based response or steps that require stockholder approval.

*Servan-Schreiber:* The principal jurisdictions in Continental Europe generally contemplate that targets can erect structural defenses against hostile bids, provided that this ability is subject to the scrutiny of takeover supervisory authorities, whose degree of knowledge and sophistication varies widely, depending primarily on the historic level of mergers and acquisitions activity in that country. While the latitude afforded to target boards to defend against hostile bids differs greatly from country to country, and the regulatory approach is not always consistent, the acceptability of mechanisms implemented by target boards is increasingly subject to a more powerful scrutiny – that of the market, especially large institutional investors.

*Mayer:* Pan-European and global institutional investors, including hedge funds, are emerging as the most important driving force in the success or failure of defensive strategies. In the Mittal Steel-Arcelor takeover battle, for example, Arcelor's first set of defenses – an extraordinary dividend, a proposed buyback, and a lock-up of a strategic asset in an independent trust – was widely accepted, as the market expected it would trigger an

improved offer by Mittal Steel. However, Arcelor's second defense – a proposed merger with Severstal of Russia, subject to a much criticized EGM shareholder veto with a 50-percent quorum – was rejected by the market and, following a further substantial improvement in the offer terms proposed by Mittal Steel, the Arcelor board had no choice but to recommend Mittal Steel's superior offer.

### **Are transactions that are tax-free to target shareholders on the rise? If so, what tax planning concerns do they create?**

*Sanders:* Under the EU Directives, as well as the domestic laws of most EU jurisdictions, transactions that are tax-free to target shareholders can be accomplished as long as those shareholders receive stock in, or other securities of, the acquiring company as their consideration. However, traditionally problems often resulted from a share exchange. In Continental Europe, most countries' corporate laws only permit cross-border combinations to be accomplished by exchange offer, unlike the U.K., which permits mandatory share exchanges under a scheme of arrangement, and the U.S., which permits subsidiary mergers using parent stock as consideration to target shareholders. Because acceptance-in-exchange offers inevitably fall short of 100 percent, dealing with minority shareholders can be difficult. As legislation implementing the new Societas Europaea (SE) and the Takeover Directive is adopted in more countries, we are hopeful that cross-border mergers will be more feasible as a technique to avoid this problem.

*Hatchard:* A second problem is what the investment banks call "flowback" – the tendency of target shareholders to sell down acquiring company shares that trade principally in another market. That is less of a problem for combinations between EU companies, but can be unmanageable for combinations between U.S. and EU companies.

### **In conclusion, how do you see the future of M&A in Europe?**

*Simpson:* In summary, the future for M&A activity in Europe looks bright. In times of economic stability, European companies will be pushed by institutional investors to consolidate to achieve larger scale and improved efficiency. The markets will continue to expect and require ever-improving disclosure standards, which are quickly catching up with standards in the most demanding jurisdictions, such as the U.S., which, in turn, will attract more investment from institutional investors worldwide.

*Servan-Schreiber:* The EU, for its part, will inevitably continue to harmonize the regulatory framework, progressively reducing the ability of governments to protect their national champions where this is not supported by a sound industrial logic, hence fostering consolidation. ●