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Europe Increasingly Turns to Special Committees in Transactions Involving a Controlling Shareholder

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Key Points

- Although more than a third of major European public companies have controlling shareholders — either holding a majority stake or exercising *de facto* control — many European jurisdictions have not developed specific procedures governing transactions with such shareholders, where conflicts often arise.
- Mandatory tender offer and squeeze-out rules in Europe provide one safeguard for minority shareholders, but in many European countries the law does not allow a board to delegate decision-making about a deal to an independent special committee.
- Such independent special committees have been established routinely in the U.K. and by some companies in continental Europe, although some of those committees have been limited to an advisory role.

A takeover offer from a controlling shareholder presents a challenge to boards of directors who are tasked with protecting minority shareholders, particularly where some of the directors on the board may have relationships or conflicts associated with the controlling shareholder.

In the U.S., decades of litigation involving controlling stockholder transactions have led to the routine implementation of certain minority protections that help mitigate judicial scrutiny, including the use of an independent board committee to negotiate the transaction, as well as conditioning the transaction on a majority of the minority vote. Sometimes both protections are used.

In addition, regulation under U.S. federal securities laws requires companies that are engaged in public M&A transactions to describe in detail the history of negotiations between the parties involved in those transactions. Such detail enables minority shareholders, regulators and other stakeholders to evaluate the behavior of all parties involved in the run up to the announcement of the transaction.

Moreover, in take-private transactions with controlling shareholders, U.S. federal securities laws require target companies, together with such shareholders, to make additional disclosures that go beyond those required in similar transactions not involving controlling shareholders, including on the purposes of the transaction, the fairness of the transaction and of materials from outside parties related to the transaction.

Due to the large number of European companies with controlling or significant shareholders, corporate law and regulation in many European jurisdictions impose strict rules regarding director independence — including codes of best practice.

In addition, European companies now often establish committees of independent directors to facilitate the review of conflict transactions. However, special committees in Europe generally operate differently, and may have less authority, than their counterparts in the U.S.; minority shareholders are not usually provided with the same level of information about the special committee's decision-making process as they are in the U.S.

Practice in the United States

Procedural Protections

In Delaware, where most large U.S. companies are incorporated, courts have held that, as a general rule, transactions involving controlling shareholders and the company they control are subject to a rigorous "entire fairness" standard of review, which requires the directors to

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prove that the process by which the board conducted the transaction, as well as the ultimate price paid or received, was fair.

Two important exceptions to that general rule have developed. First, Delaware courts have held that the burden will shift to the plaintiff to prove that the transaction did not satisfy the entire fairness test where a board of directors implements one of two procedural protection mechanisms:

i. a well-functioning special committee, comprised of independent and disinterested directors, with bargaining power (*i.e.*, the ability to say "no" to a proposed transaction), or

ii. a non-coercive majority vote by the fully informed minority shareholders.

Second, where the board implements both of these mechanisms before any economic negotiations commence, and the deal is conditioned on using both of these mechanisms on a non-waivable basis, the board's decision will be entitled to deference under the business judgment rule and will not be subjected to review under the stricter entire fairness standard, despite the inherent conflict between the minority and controlling shareholders. When the business judgment rule applies, the court presumes the board has complied with its fiduciary duties and will not second-guess the board's decisions, unless the decision is clearly irrational or constitutes waste.

Special Committee Criteria

To qualify as a well-functioning special committee under Delaware law, the committee must:

- Consist of disinterested directors independent of each of the company, the potential bidder (including a controlling stockholder) and anyone acting in concert with the bidder. Independence factors include financial interests, board or management positions, personal relationships and influence from interested parties.
- Have a clear and broad mandate allowing it to evaluate, negotiate, consider alternatives and, importantly, even reject a transaction. The committee must also be empowered to retain independent legal, financial and other advisors of its choice.

Mandatory Disclosure Obligations

The Delaware courts have held that, to ensure that the minority shareholders are fully informed, all material facts that are relevant to the shareholder vote on the proposed transaction must be disclosed.

In addition, U.S. federal securities laws impose disclosure obligations on both the controlling shareholder and the public company. The information they must provide includes:

- A history of the negotiations and material contacts between the parties engaged in the transaction during the past two years.
- A discussion of the purpose of the transaction, including alternatives considered; reasons for the structuring and timing of the transaction; and a description of the impact on the company and certain other stakeholders.
- A statement about the substantive and procedural fairness of the transaction.
- All reports, opinions and appraisals from outside parties that are materially related to the transaction, including those provided to the board or the special committee in draft form.

As a result, minority shareholders, regulators, courts and other stakeholders are able to evaluate the decision-making process of the special committee in detail. And the knowledge that the negotiations will be described in full detail encourages arm's-length negotiations between all parties involved in the transaction.

Practice in Europe

Procedural Protections

While most U.S. public companies are widely held, many continental European companies have a controlling or major shareholder, with the U.K. falling somewhere between the U.S. and continental Europe. In response, many continental European jurisdictions and the U.K. have developed robust director independence requirements that focus on independence both from the public company and its significant shareholders.

> Special committees in Europe generally operate differently, and may have less authority, than their counterparts in the U.S.

Historically, continental European directors with a conflict would simply refrain from participating in discussions related to the transaction. But growing public scrutiny concerning corporate governance and conflicts of interest — including by U.S. shareholders investing in continental Europe — has compelled independent directors to take a more active role on conflict transactions and more clearly exclude the conflicted directors from decision-making, including by forming committees of independent directors who meet separately from the full board.

This reflects long-standing practice in the U.K., now driven by the requirements of the Takeover Code that shareholders receive a recommendation from the board of a target company regarding an offer

for its shares and that directors with a conflict should be excluded from making the recommendation. Special committees have recently been formed for several deals involving Dutch-incorporated companies, for instance.

However, the law in some jurisdictions in continental Europe — including France and Germany — makes the use of special committees difficult. For example, under French law, a board is not able to delegate decision-making to a committee, as committees have no such power and can only advise the full board. And in some jurisdictions, all board members retain full accountability for all board decisions.

European jurisdictions, including the U.K., have established additional mechanisms for protecting minority shareholders. For example, under the U.K. Takeover Code and the EU Takeover Directive, which has been implemented in the EU member states with slight variations between such states, shareholders who acquire an interest of 25% to 33.33% or more (or in some jurisdictions such as the U.K., but not all, increase their stake when they already hold between 30% and 50%) are generally required to make a mandatory offer for the balance of the shares, subject to the terms and restrictions of the relevant law.

Further, in the U.K., the shares of the bidder and parties acting in concert with it are not counted in the shareholder vote to approve a takeover of a company effected by means of a court-approved scheme of arrangement (rather than a contractual tender offer). In other words, support of a majority of the minority shareholders is required. Similarly, shares held by a bidder and its concert parties would not count toward the threshold for a compulsory squeeze-out of minority shareholders following a tender offer for a U.K. company.

While continental European jurisdictions typically do not require the approval of the majority of the minority in conflict transactions, most require a bidder to control 90% to 95% of shares before it can conduct a squeeze-out, compared to 50% in Delaware. That incentivizes the bidder to persuade the great majority of minority investors to tender in order for the bidder to obtain 100% control (although having such a high threshold sometimes results in holdout shareholders demanding more consideration).

Regulation is catching up with advocacy and investor pressure. For example, Italy has implemented legislation mandating that special committees issue opinions for certain conflict transactions, although such opinions are advisory in nature.

Mandatory Disclosure Obligations

Disclosure in continental European M&A transactions is generally governed by home country laws implementing the EU Prospectus Regulation, and the U.K. has implemented similar legislation. In most jurisdictions, the competent regulator will review and approve a disclosure document before it is issued to shareholders.

However, the disclosure rules are less extensive than in the U.S. For example, they do not require detailed descriptions of the history of negotiations and the purpose of the transaction. Further, in some jurisdictions, disclosure rules do not differentiate between transactions with controlling shareholders and other transactions and, in any event, do not require publication of the history of advice, opinions and reports delivered to the board or the special committee.

As a result, while minority shareholders and interested parties have detailed descriptions of the transaction terms and the final recommendation of the board and/or the special committee, the law does not require the parties to describe the process by which the final terms and recommendations were reached, which can have substantial effects on how the negotiations and transaction processes are run.

In Sum

To address conflicts inherent in transactions involving controlling shareholders, case law and regulation in the U.S. have prioritized board implementation of procedural safeguards for minority or unaffiliated stockholders, including special committees and majority-of-the-minority approvals, and robust public disclosure.

European jurisdictions, responding to such conflicts and heightened investor scrutiny, have seen an increase in the implementation of special committees and, to a lesser degree, majority-of-the-minority approval thresholds; however, each jurisdiction in continental Europe and the U.K. has put a unique spin on how these protections are implemented.

While disclosure rules for public M&A transactions in the U.S. and Europe have converged over the last 20 years, those rules remain substantially more detailed in the U.S., particularly when it comes to controlling shareholder transactions. They require greater disclosure obligations from special committees of U.S. companies while at the same time encouraging arm's-length dealing at all stages of the transaction.