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INTERNATIONAL FINANCIAL LAW REVIEW

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The secret to investing in China

Regulators: don't overreact
Sovereign wealth should not be feared

When to disclose derivatives
The UK's new rules on building stakes



Private equity and venture capital review

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Private equity and venture capital review

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Now you can check out

In the past, investors in permanent capital sometimes felt like they were at the Hotel California. They could check in, but they couldn't check out. Well now they can call the bellboy and hail a cab. And Special Purpose Acquisition Companies (Spacs) are the reason why.

The equity vehicles for one-off acquisitions are proving popular – Wall Street earned \$770 million in 2007 from the sale of shares in 64 Spacs. Investors are attracted by the entrepreneurial records of the people setting up the fund. And the risks are minimal. Typically, a Spac has 18 to 24 months to find a suitable target. Once it has, 80% of its shareholders have to approve the target. If the vote succeeds and an investor voted against it, it can withdraw and take its money back.

But things can be even easier.

Euronext Amsterdam is rapidly becoming the place to list European Spacs. Unlike in London, Spac shares on the Dutch exchange are not suspended from trading when a potential acquisition is announced.

“Now private equity investors can call the bellboy and hail a cab”

So Spacs can make a call on whether their shareholder vote will succeed or fail based on an analysis of the share price, and whether it rises or falls. More importantly, investors that see their Spac shares spike, but feel the proposed acquisition is wrong, can sell directly over the exchange. For a profit.

This benefits the Spac too as it means that the shareholder vote is more likely to go through and have a percentage mandate in the high nineties.

London changed its rules to allow permanent capital onto its exchanges last year. It will have to amend them again to allow shares to continue trading when a Spac acquisition is announced. Otherwise all the European Spac investors will be checking in and out whenever they please in Amsterdam.

Nicholas Pettifer

Mac clauses come to Asia

Buyers and their counsel in Asia are learning lessons from the US, as material adverse change (Mac) clauses have begun to appear in M&A documentation.

Although the clauses have traditionally been rare in public deals in Asia, they are increasingly being used in both Hong Kong and Singapore.

A survey carried out by Stamford Law has found that three out of five public Hong Kong deals in 2007 included Mac clauses, a sharp rise from previous years.

Mac clauses aim to give the buyer the right to walk away from an acquisition after it is announced, but before it closes, if certain events occur that are detrimental to the target company.

With financing so readily available until last summer, the clauses have traditionally been either accommodating to the seller, due to the pressure of rival buyers, or absent altogether. This has changed, though perhaps not purely because of the credit crunch.

“There has certainly been an increase over

the last couple of years – but I haven’t seen a sudden surge in the last few months due to the situation in the US,” said Barbara Mok, partner of Jones Day’s Hong Kong office.

The US buyer’s tendency is to incorporate generally worded clauses to allow them a swift exit.

“As a Hong Kong lawyer, I’m more accustomed to UK, common law techniques. But we’re starting to see the influence of US Mac clauses,” said Mok, adding that Hong Kong courts nevertheless tend to be more protective of the seller.

Under the Hong Kong system, the buyer can only rely on the Mac clause if the change is such that it frustrates the purpose of the agreement or strikes at the heart of the deal. In short, it favours the seller.

And in Hong Kong especially, general changes to market conditions or those affecting the industry sector in which the target competes aren’t thought to be enough to warrant a Mac clause – though bidders are increasingly pushing for such clauses when negotiating takeovers in the US. **TY**

Japan creates new, unregulated poison pill



Just months after the last spate of poison pills, Japanese companies appear to have come up with another scheme for blocking hostile bids. The new measures are poison pills by name, but nothing like the ones buyers and their counsel are reluctantly used to.

The new style of defence measures are embedded in financing schemes which combine loans with warrants. If exercised the warrants would dramatically dilute the stakes of shareholders and defend against unwelcome bidders.

Two Sumitomo Group companies recently raised funds by taking out loans with warrants. Sumitomo Realty raised ¥120 billion (\$1 billion) this month through a subordinated loan from Sumitomo Banking Corp (SMBC). The loan has warrants that have a moving strike price. In response to a takeover bid, SMBC could exercise its right to the underlying shares, creating a problem for the bidder.

Sumitomo Realty denied the scheme was designed to defend against takeover bids. However, it is not clear what other uses it could have.

“Apparently this [new structure] is a reality. And what else are the companies in question going to use it for?” said Paul O’Regan, head of Clifford Chance’s corporate group in Tokyo. To make matters worse, related party transactions and non-pro rata allotments of shares are not regulated, either by law or the Tokyo Stock Exchange.

“These warrants are designed to dilute the shareholding of an unwanted suitor, but also dilute that of a normal shareholder. Where else in the world could that happen, at least without shareholder approval?” said O’Regan.

Loans with warrants attached are not new. Banks have been using them for financing private equity-backed leveraged buyouts, granting them a portion of the upside. “But this has obviously been latched onto as a scheme that can fulfil another purpose,” said O’Regan.

The news comes just weeks after Japan’s Financial Services Authority released a report outlining plans to strengthen the country’s financial markets, which included a promise to improve regulation and allow competition. **TY**

Hedge fund listings to flood London

MW Tops’ plan to list in London due to a rule change is set to spark a flurry of similar moves in the market.

The €1.4 billion Marshall Wallace feeder fund listed on Euronext Amsterdam in December 2006 because of a restriction on the listing of single strategy hedge funds in London.

But to ensure it doesn’t lose out, London changed its rules on March 6. An overhaul of the system means that, among other things, feeder funds can now undertake a primary listing under chapter 15 of the UK listing rules. MW Tops is the first fund to take advantage of this shift.

“There are definite benefits for funds due to this change. For example, there is greater liquidity for shares as London is a broader and deeper market. Also, being listed in London means the chance of being included on the FTSE index thus opening up funds to tracker products,” said Nigel Farr of Herbert Smith, advisor to Marshall Wallace.

“There aren’t that many other funds on Euronext, but they are big. There’s got to be a chance that they will follow. It’s not particularly expensive or difficult to do.”

The rule changes are being seen as a general liberalisation of policy. For example, the super-equivalent requirement that fund managers must have “sufficient and appropriate” experience to list has been scrapped. Also, quarterly disclosure of significant holdings is no longer needed.

In an issue more specific to MW Tops, the rule that directors of feeder funds had to make up the majority of the directors of the master fund has been relaxed. LR15.2.6 is the key to allowing feeder funds to list. It states that if an investment entity principally invests its capital in another company’s fund, it must control the policy of that entity. This is still a restriction, but it is more liberal and principles-based than its predecessor.

Pressure on London to change its listing rules began in earnest when KKR opted to list its \$5 billion offering in Amsterdam in May 2006. The debate was ramped up when single strategy hedge funds such as MW Tops started to list in Amsterdam later in the same year. This led to a UK Listing Authority (UKLA) announcement that chapter 14 didn’t ban overseas investment companies from a secondary listing. Brevan Howard tested this by listing its feeder fund BH Macro for \$1.1 billion in March 2007. Third Point and Ashmore Global soon followed suit.

This outraged the Association of Investment Companies and the Treasury Select Committee as foreign investment entities were listing with fewer requirements. As result, a rewrite of the listing rules was agreed. As of March 6, chapter 15 has been liberalised, but the chapter 14 route will be shut for investment entities.

2008: year of the Spacs?



As the financial world dives deeper into a bear market, Special Purpose Acquisition Companies (Spacs) look to be replacing permanent capital listings.

"Spacs have had a pretty profound transformation in the last 18 months. The type of managers involved has improved, as has the involvement by the

bulge bracket firms," said Quentin Nason, managing director for equity capital markets at Deutsche Bank.

Indeed, December saw Bear Stearns dip into the Spac market for the first time by underwriting MVC Acquisition for \$200 million.

The initial public offering (IPO) of Liberty Acquisition

Holdings was the first of these publicly traded buyout companies to break the \$1 billion mark when it listed on the American Stock Exchange in November.

And last week saw Spacs move to Europe when Liberty International Acquisition raised €600 million (\$880 million) on Euronext Amsterdam. This has prompted talk of a trend.

China private equity is running out of ideas

Investors in China are running out of structures to take over local companies, it emerged at this year's IFLR M&A Forum in Hong Kong.

A senior figure at one private-equity house, speaking at the conference, complained that the traditional methods of investing in targets were becoming harder, due to a combination of protectionist regulators and dwindling targets.

"From January to March this year, we have attempted 16 deals in China, but none of them are still alive," he said.

Three of the deals involved the target having an offshore holding company in Hong Kong – a traditional way to bypass the approval of the

country's Ministry of Commerce (Mofcom), before listing the company on a foreign stock exchange.

However, according to the speaker, two of the three targets with such a structure were "abysmal", indicating that desirable targets with offshore holding companies are running out.

Other failed bids were onshore investments, a technique where the foreign investor forms a joint-venture with a China partner, before allowing that partner to invest in the onshore company, again bypassing foreign investment approval.

But the nature of foreign-invested enterprises makes onshore investments difficult. In the US, for example, investors have access to both

preferred and common classes of stock. China has only one class of equity. This removes preferential rights associated with private equity investments, like preferential payment of dividends and liquidation proceeds. These deals were failing too, said the speaker.

The remaining targets involved offshore investors investing into onshore companies with no assets, and investors purely having access to the cash flows of the target. This option was also proving unpalatable.

The comments came during 'The China Factor in Global M&A' at this year's Asia M&A forum, co-hosted by Inter-Pacific Bar Association and IFLR at the Island Shangri-La in Hong Kong. **TY**

"Spacs are a bear market product and this bear market really has its teeth into us. It looks like Spacs will step up to the plate," said Nason.

Spacs are designed to raise money via public a public offering before they look for a suitable target. Typically, Spacs are sold at \$6 each for one share of common stock and two warrants for the purchase of additional shares. Most Spacs have a two-year time limit to find a target and funds are returned to investors if this lapses.

In terms of fees, investment banks usually take around 10% and if a bid is successful, the management team takes 20% of the acquired company's profits. The shareholders get ownership on the acquired company.

In 2007, Wall Street earned \$770 from the sale of shares in 64 Spacs, which helped counter the reduction of earnings overall for IPOs. In 2006 there had only been 36 Spac offerings on Wall Street. European exchanges will be hoping that Liberty International Acquisition will spark a similar turnaround.

However, one private equity partner at a magic circle firm in London is not convinced: "There are lots of Spacs in the pipeline, but I heard similar predictions of growth in Europe last year and not much materialised. Considering today's environment, I am not sure that these vehicles will be something that people will invest into blindly."

While it is true that Spacs raise funds via a blind pool and don't specify a target until after the IPO, there are other features that may attract investors in turbulent markets.

First, 70% of shareholders typically have to agree to the acquisition target before the bid process commences. More importantly, most Spac funds are held in trust. So even if a suitable business for purchase can't be found, investors are likely to at least break even. **NP**

You need local funds to succeed

International private equity houses operating in China should create locally denominated funds to invest successfully. Kathleen Ng from Asia Private Equity Research discusses why

Private equity lawyers advising on investment into China are at a loss. Although investors are keen to make deals happen, many are collapsing due to protectionist regulation and a fall in the number of adequate targets.

Typically, Chinese targets would have a holding company based in Hong Kong. But investors are finding such companies thin on the ground. As described in the news analysis section ('China private equity is running out of ideas'), forming joint-ventures with a Chinese partner to invest is also failing. Bypassing foreign investment approval is getting harder.

Kathleen Ng is the managing director at the Centre for Asia Private Equity Research, which analyses and packages data for the industry. She highlights the popularity of renminbi-denominated funds in China.

IFLR: Foreign private equity is facing a lot of protectionism in China. They try new structures, but still face strong opposition. Will this change?

Kathleen Ng: Not immediately. One of the most important developments in China has been the introduction of the government's active support of renminbi-denominated funds. This is actually changing the whole landscape of private equity. When you have a vast pool of local denominated money available for investment, it is only natural for the local companies to come to you. They speak the same language. Also, it only takes two weeks to get approval from the central

“This will reshape the whole of the private equity industry in Asia”

government as to whether it will invest or not. With foreign funds, it can take six months or longer. There is no guarantee that the government would approve the transaction either.

So if you are a company seeking to raise funds, why would you opt for the latter? There will be trend of foreign private equity houses beginning to look at how they can launch a locally denominated fund to access this sort of bankable company and keep the deal flow going.

By hiring local people and so developing a stronger relationship with the client base?

Exactly. So the trend will continue, and this is very much what Beijing wants to see. For a long time, a lot of the gravy has been earned by foreign private equity people. Profit is ok, but the government wants the locals to have a share.

Will the Chinese government allow a flood of foreign private equity houses to set up these funds?

The locally denominated funds only started setting up a year ago, so it is very early days. I don't think the government has ever thought about what would happen if large numbers of foreign funds come in and set something similar up. Obviously there would be a lot of regulatory hurdles to overcome, but the potential is there for a lot of funds to develop. Some foreign investors have told me that this is the way to go. They need to work in the local way in order to access local deals and recruit local people. If this trend continues, it is going to reshape the whole of the private equity industry in Asia. Historically private equity has been dominated by dollar-denominated funds with the players in Europe and the US dominant. Now you have local renminbi funds being launched and the market is very different. It is going to be very interesting to see how Beijing shapes future development.

My feeling is that the government is looking to use private equity and venture capital to help local industries to grow, to improve management, governance and so on. On the other hand, they don't want foreign private equity to absolutely domi-

“When you have a vast pool of local money, it is only natural for local companies to come to you”

nate. This was the premise behind launching the locally denominated funds.

How many of these funds are there?

Last year there were four or five local funds in China and they raised at least \$10 billion. One was launched over a year ago, called Bohai Industrial Investment Fund. The total fund size was over \$1.2 billion. Every single fund that they launch is at least at the \$1 billion mark.

Does India follow a similar model?

India hasn't launched a locally denominated fund of any substantial size that we are aware of. It is feasible, but there haven't been any large ones. There are a lot of foreign investors though – India for one reason or another is the first port of call for lots of technology investors. A lot of them are raising the funds specifically for India too. But all of these funds are denominated in US dollars.

But both China and India are the hot countries for private equity?

Yes. In 2007 for the first time both China and India overtook Japan. For a long time Japan dominated the Asian private equity scene in terms of fresh capital investors and transaction volume. Because of the sheer size of Japan's economy, invariably it attracted very large funds. It was also the hub for buyouts.

Also, the emerging markets in Asia have consolidated their position. In 2006, Australia was a very hot market in terms

of buy outs. If I remember correctly, Australia topped the markets with over \$14.1 billion of transactions. In 2007 this dropped dramatically.

The investment figures in Australia and Japan have dropped, so two of the developed economies in Asia that were dominating the buyout scene have become less prominent. Instead China and India are in charge.

Why do you think this has happened?

It is probably because of the growth potential of both countries. They are so enormous that you a lot of private equity investors are deploying capital. A lot of this capital has been taken away from developed countries.

For example, the failure of the consortium of investors to take over Qantas in Australia was a defining deal. At the time, the board was recommending the offer to the shareholders and said that the Qantas shares would drop if they didn't take up the proposal. It didn't happen that way. Qantas shares continued to climb after the buyout deal failed. The shareholders were really questioning the board. I think the board failed to win the confidence of shareholders. A lot of them were unsure and didn't believe that the board's advice was in their best interests. Since then we have seen a sea change in the shareholders of target companies themselves. A lot of them have opposed buyouts.

Why has investment moved from Japan to India and China?

The Japanese economy improved in late 2005 and in 2006. A lot of the companies were able to raise money from the stock market. Also, there has been a trend of Japanese companies discouraging buyouts from parties that they don't know. That together with the improved stock market led to a slip in the transaction value of buyouts.

On the other side, investors are just pouring money into India and China. In addition, investments in China and India that were made in the early years of the industry are beginning to show very handsome rewards. This is extremely important because for a long time people thought that Asian private equity was a black hole. Especially in China – you couldn't get any return. This theory has been quashed. Both India and China have been able to demonstrate that they can consistently provide returns to investors. And some of the returns have been extremely enticing. This gives people the impetus to invest.

Moving onto other jurisdictions, are other emerging markets easing their stance on private equity?

I think that Taiwan is opening up to foreign private equity. The valuation of companies is much more attractive compared to China. The multiples that the companies in China are asking are extremely high because of the growth potential. Private equity investors are very simple – you find a place where you can buy at low multiples. You have to have an attractive entry price.

We have actually seen private equity investors happily going into Taiwan and this will accelerate with the new political regime in the latter part of next month. The new regime headed by Ma Ying-jeou will advocate a lot more of the economic ties between China and Taiwan, rather than the stand-offish policy of the last government. We see the tension between these two markets relaxing. This month the first group of property developers from China is actually going to visit Taiwan. This is a landmark event – people from China are investing in Taiwan. A situation like this gives people a huge level of confidence.

Taiwan was one of only two Asian markets in 2007 that had a consistently increasing surge of capital from investors. Overall, Asian private equity slowed down, but Taiwan increasingly attracted money from private equity. We will see more activities there. There is no doubt about it.

Are other Asian jurisdictions showing growth?

Private equity is beginning to focus on south-east Asia. In particular, Vietnam is seeing a lot of movement. A lot of funds are being raised there too.

There is always some early movement in Cambodia. This is almost a repeat of 1996 – just before the Asian financial crisis – when a lot of people were very keen about these south-east Asian markets. On

top of that we also see a lot of very strong investment into Malaysia. Some of the deals by foreign private equity investors are very substantial too. So even though Malaysia has currency controls, people are finding ways to hold assets. Principally because of the fact that you can also sell your asset at a very profitable return.

The south-east Asia market, which has been in a slump since the 1997 financial crisis, is now able to show that it can produce a very handsome return. Having said that, the only market that is finding it hard to attract investment is Indonesia. Investors are still trying to digest how the economics there work. We don't see a surge of interest in Indonesia yet. But I believe a lot of people are looking at it, and if the government can maintain political and economic stability, they may be able to convince some to go back there.

What do you forecast for 2008/2009?

It splits into two distinct areas. The avalanche of capital coming into the market from abroad will continue. Asia is the growth centre of the world – there will be no respite. More funds will be launched.

On the investment side, deals will be very competitive because there is only a defined number of quality companies. In Asia we simply do not have a sufficient pool of quality companies for those coming into the market. So you see increased competition for deals.

Also, there could be growth in the buyout industry. Last year was a bad one for buyout investors – they just didn't seem able to close deals. But given the volatile stock market, I think that some people will be talking to buyout investors and looking to offload some of their non-core assets. There will be a slight increase in buyout activities, but not a great deal. Certainly not like it was in 2003/2004.

“We have seen a sea change in the shareholders of target companies themselves. A lot of them have opposed buyouts”

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Don't overreact

Whatever you do, don't panic. Sovereign wealth funds have been around for a while and are nothing to fear. Regulators are thankfully realising this and are ignoring politicians

IFLR's journalists in London, New York and Hong Kong all agree: people are overreacting to sovereign wealth funds.

These controversial investment vehicles have become increasingly political since the turn of the year. French President Nicolas Sarkozy spoke out against them and German Chancellor Angela Merkel reinforced her stance against them. Even in the midst of the US race for President, Hillary Clinton tried to turn the topic into a vote winner.

But lawyers all round the world say the same thing: sovereign wealth funds are old news, there is no need to panic and any reaction needs to be a considered one.

At the moment, it is estimated that the top sovereign wealth funds hold around \$2.5 trillion in assets. By 2015, this is expected to have risen to \$12 trillion. China Investment Corporation can already afford to buy Morgan Stanley four times over. Imagine what it could purchase by the middle of the next decade.

After the whirlwind of speculation at the turn of the year, the inevitable regulation of sovereign wealth is starting to take shape. Lawyers were worried that a regulatory response could turn into protectionism, but it looks like action will not be as over zealous as many feared.

Europe outlines regulation

The European Commission (EC) is pressing ahead with a voluntary code of conduct for sovereign wealth funds.

At the end of February, European Commission president José Manuel Barroso issued a statement during his official visit to Norway. While admitting that sovereign wealth is "not a big bad wolf at the door", he

drew upon the transparency of Norwegian funds as a paradigm for other funds in Europe.

"A code of conduct has been inevitable since the furore over sovereign wealth started at the turn of the year," said a funds partner at one US law firm. "But that doesn't mean it was required. This will just quieten political panic and make it look like serious action is being taken."

But Barroso justified his statement by saying that a level playing field will benefit Europe as a whole: "We will propose a common approach at European level, avoiding distorting the single market with incompatible national responses. This EU approach should benefit both investor and recipient countries."

Barroso's plans were confirmed later in the same week in Commission proposals released, which were designed to direct discussions of European leaders at the spring European Council on March 13 and 14.

The proposals called for the leaders to agree to a voluntary code of conduct. In particular, it hoped this would encourage some "opaque" funds to disclose the value of their assets, investment objectives and the nature of their risk management systems.

Ironically, these proposals may have prevented stronger regulation. By calling for a code of conduct the Commission has stumbled across a middle ground. European leaders such as German Chancellor Angela Merkel and French President Nicolas Sarkozy will have found it hard to get backing for legislation with a more moderate proposal on the table. Neither has publicly declared their desire for heavy regulation, but their stance has been obvious from anti-sovereign wealth statements.

Indeed, the Commission's proposals seemed to strike a chord with the Economic and Financial Affairs Council (ECOFIN) who met on March 4 to discuss sovereign wealth funds to prepare the discussion of the full council nine days later. As a result, the presidency conclusions from the mid March meeting in Brussels said:

"The European Council agrees on the need for a common European approach taking into account national prerogatives, in line with the five principles proposed by the Commission, namely: commitment to an open investment environment; support for ongoing work in the IMF and the OECD; use of national and EU

instruments if necessary; respect for EC Treaty obligations and international commitments; proportionality and transparency.

"The European Council supports the objective of agreeing at international level on a voluntary code of conduct for sovereign wealth funds and defining principles for recipient countries at international level."

But opponents to sovereign wealth regulation should not rest easy. Any voluntary code of conduct could be hardened at a later date. This was a lesson learnt by the private equity code of conduct in the UK last year.

And Barroso refused to rule out further action: "We will not propose European legislation. Though we reserve the right to do so if we cannot achieve transparency through voluntary means."

Australian regulation

But sovereign wealth fund regulation started in the southern hemisphere in February. Australia issued specific international guidelines on government-backed investors before the EC announcements.

The country unveiled a set of screening criteria governing sovereign wealth fund investments, which will be used by regulators to judge foreign, namely sovereign wealth fund, bids. Among the six guidelines is whether the investors "are independent from the relevant foreign government," including the extent to which they operate at arm's length from its government and whether they are controlled by a foreign government, including funding arrangements.

Others include whether the fund follows common standards of business behaviour showing clear commercial objectives and good corporate governance practices.

As a member state of the OECD, the body responsible for designing a code of conduct for recipient countries, it is likely that Australia's set of six principles will be similar to the organisation's final suggestions. And although the announcement is the first solid piece of regulation on the matter, the six principles are little more than official statements on current practices.

"This seems to be the beginning of a very long process for sovereign wealth fund regulation. The Australian government appears to be saying that this isn't the last word but the beginning of the conversation," said Stephen Harder, a China partner at Clifford Chance. "Also, calling them six principles makes them sound more tangible than they are. We have to remember that [the Australian government] is reiterating several powers that it already has," said Harder.

Harder also believes that through a cumulative process of failed and successful bids investee countries and the corresponding for-

**"Don't overreact,
don't over-regulate,
don't over-control,
don't over-legislate"**

Angel Gurria,

OECD secretary general

eign sovereign wealth funds will develop an almost common law-style set of precedents for which types of transactions go forward and which do not. “But once we start seeing really large investments, very few countries will not reserve the right to consider political issues raised by the target’s new ownership structure,” he added.

Europe: stop panicking

In January, IFLR’s journalists brought together the opinions of lawyers world wide on the issue of sovereign wealth. The overwhelming message was: “don’t panic”.

For example, Standard Chartered claimed that sovereign wealth funds are potentially “irresponsible participants in the world economy.” This was an overreaction, according to UK counsel.

In an interview in mid-January, the bank’s chairman Mervyn Davies called for a code of conduct to create more transparency. This was significant given that Temasek, the Singapore state fund, holds an 18% stake in Standard Chartered.

One UK corporate partner reacted by saying: “I don’t understand all this fuss about sovereign wealth funds. Qatari funds have been active in London since the early nineties and no one has ever made a big deal about it.

“The national papers have suddenly latched onto them in much the same way that they did with private equity last year. It’s pure scare-mongering.”

But it was exposure in the media and public pressure that led to Sir David Walker drafting a private equity code of conduct in November last year.

The focus on sovereign wealth funds can be attributed to the governments of Kuwait, Singapore and South Korea providing most of the \$21 billion lifeline to Citigroup and Merrill Lynch earlier in January. The media sunk its teeth into this and it is unlikely to let go easily.

“A code of conduct would only serve to quieten people who are panicking for little reason,” the UK corporate partner continued. “No one was concerned about transparency of sovereign wealth funds before, why should they start now?”

Lessons should also be learned from last year’s UK private equity code. People quickly realised that the code was merely a sop to their concerns and there is now pressure to strengthen it. If a similar code is drawn up for sovereign wealth funds, it will have to have more weight to it.

Some at an international level are also arguing that policy makers need to avoid over-zealous regulation that could smack of protectionism. The day after Davies’ comments, secretary general of the OECD Angel Gurría issued a warning to regulators.

“The OECD is saying buyers have to have transparency, abide by market rules. But sellers: don’t overreact, don’t over-regulate, don’t over-control, don’t over-legislate. They are helping investments, solving some of the problems, like global imbalances. They could become sovereign development funds,” he said.

US: It’s a liquidity boost

Lawyers in the US also say that sovereign wealth should not be feared. Indeed, it will help improve liquidity.

“One factor is their huge dollar surplus, which needs to be invested. Putting that in the US is a good thing overall,” said Paul Lee, partner at Debevoise & Plimpton.

Many say the increased deal speed that is possible at sovereign funds will help the US steer clear of recession. It could reduce liquidity problems at America’s large banks, and help to keep loans flowing.

Deals are often processed faster within sovereign funds as they are subject to less regulation and have a streamlined internal decision-making process, unlike pension funds and other large investors.

That lack of regulation could be a cause for concern, but lawyers point out that the funds rarely take more than a 5% stake in the company, suggesting they do not intend to take over any part of it. The acquisition of less than 5% of voting securities establishes the presumption that the acquirer is not taking control.

Investors would only gain a voice in the management of the company if they held more than 5%. That would involve greater regulation and so transparency. An acquirer of 5% or more of voting securities of a public company must report the acquisition to the SEC; 4.9% acts as a reporting and regulatory clearance threshold.

“The natural inclinations of sovereign funds are consistent with the natural inclinations of investors in the US financial sector. Those normally mean acquiring no more than 4.9%, or in some cases 9.9% of the financial institution,” said Lee.

These sovereign funds also don’t rely on leverage, which has been a source of concern around hedge fund investments. Sovereign funds have a more stable capital base, which permits long-term investments. They can also tolerate greater risk.

Some in the US are scared that these funds will dominate financial institutions. But even though Wall Street has already accumulated \$59 billion of investment, Lee said that “in the financial sector, it’s less likely that one would see sovereign foreign investors acquiring a controlling stake”.

One suggested solution for concerns over transparency is for sovereign funds to agree to

The political (over)reaction



“This is about protecting important industrial sectors”

German Chancellor Angela Merkel



“We will protect innocent French managers from the extremely aggressive funds”

French President Nicolas Sarkozy



“China Investment Corporation is entirely commercial”

China’s Premier Wen Jiabao



“We need to have a lot more control over what they do and how they do it”

US presidential candidate Hillary Clinton



“The British commitment to open markets means we will welcome sovereign funds”

UK government official

Why is IMF meddling with sovereign wealth?

Last month's IMF announcement stating that it is developing best practice guidelines for sovereign wealth funds has received a muted response.

"The current economic climate is a perfect storm for political discussion to happen in public. The IMF is a voice in the discussion, but a relatively small voice," said John Douglas, regulatory partner at Paul Hastings Janofsky & Walker.

"I'm not belittling it, but the IMF proposals will have a modest impact. [The US] political process is full of people who think they are kings and queens in their own right."

On March 21, the IMF executive board approved further analysis on how sovereign wealth fits into the global economy. More importantly, it agreed that IMF staff should work with sovereign wealth funds to develop best practice. The board also established an international working group of sovereign wealth funds to aid discussions and begin drafting proposals next month.

The main issues the IMF will look to develop best practice on are public gover-

nance, transparency and accountability. It will also coordinate its work with that of the OECD.

But it is hard to see why the IMF is investing time in this area. As detailed in the main body of this article, the European Council recently met to approve the European Commission's plans for a voluntary code of conduct.

Douglas felt that the US Congress would make its own mind up, even if an IMF voluntary code was established:

"For instance, you'd think the relatively small sovereign wealth investment in Blackstone wouldn't create much fuss. And it almost certainly would have complied with any proposed code of conduct. But if Blackstone were then to invest in the defence industry, the issues would rush to the fore," he said.

Even with the IMF guidelines, it is hard to see the US government relying on them if sovereign wealth remains political. The Committee on Foreign Investment in the United States (Cfius) would probably be tightened and the US Treasury would likely come up with its own code of conduct.

a code of conduct, rather like that imposed by private equity funds on themselves. Canada has already declared something similar, with funds being required to have independent Canadian boards and commit to selling to Canadian consumers (see box at the end of this story).

Some also point out that, despite the high-profile investments in Citigroup and Merrill Lynch, these funds are nothing new to the US.

Foreign states have been recycling the dollar back into the US for years. The difference now is that the declining dollar encourages foreign investors to turn away from treasuries and into stock.

Australia: Controversial, but here to stay

Sovereign wealth funds are creating the same reaction in the southern hemisphere. They

may be causing equal measures of panic and glee among central governments and flailing investment banks, but it would appear that the legality of their dealings cannot be questioned.

China's State Administration of Foreign Exchange (Safe) purchased stakes in three of Australia's largest banks in late December, attracting some opposition. Complaints centred on Safe's denial of the investments, and its request that the *Financial Times* not publish details of the stake. Some observers also questioned why Safe is making the kind of risky investment that China Investment Corp, the country's sovereign wealth fund, is supposed to be responsible for.

However, the investments are comparatively small, with each stake worth A\$200 million (\$176 million), and fly well below the threshold of equity investments needing regulation in Australia.

Australia and New Zealand Bank and Commonwealth Bank of Australia said Hong Kong-registered Safe Investment Company had bought stakes of less than 1% in each of the lenders.

"We're speaking about very minor levels here," said David Olsson, capital markets partner at Mallesons Stephen Jaques' Melbourne office.

"There is a political element to these complaints. But providing everyone follows the same rules, there can't be too many objections. From an Australian perspective, once we reach 10% to 20% and there is a significant equity interest, there is obviously an increase in regulation," he added.

As already mentioned, Australia has since outlined its regulatory response to sovereign wealth. Australia also has a foreign investment review board which would evaluate any investments on national merits should they reach such a level.

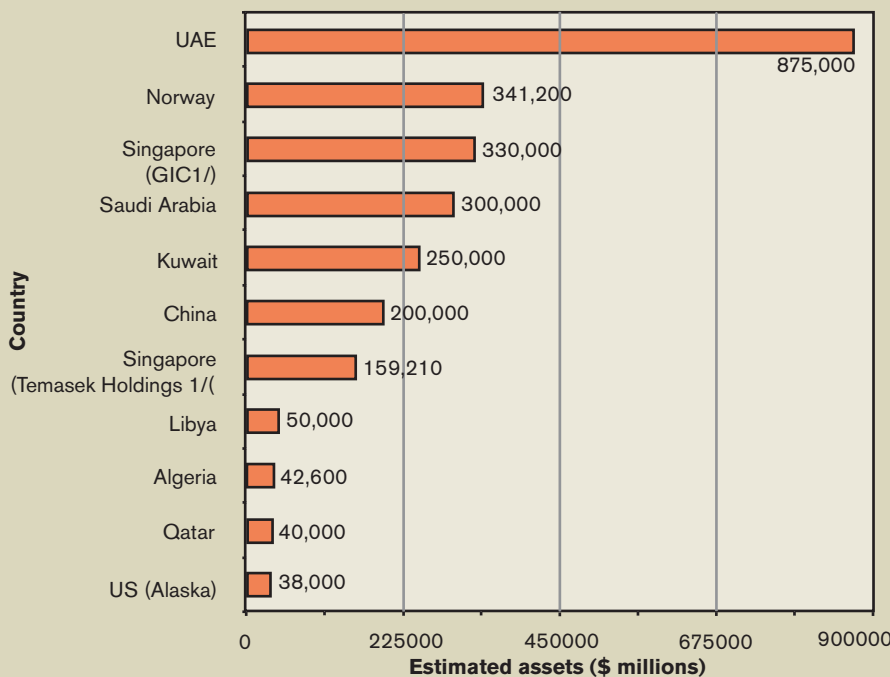
Inevitable change

Despite the fact that they are nothing new, sovereign wealth funds will continue to strike fear into politicians. This is because the central issue is a lack of transparency, and so a lack of control.

Sovereign wealth funds will have to change the way they operate. In Europe, private equity has had to succumb to a code of conduct. And hedge funds have begun to follow a similar route. If they want to maintain their investment plans overseas, sovereign wealth funds will have to find similar ways to mollify opposition. Adhering to the rules set down by regulators would go a long way to pacifying the sensational focus on sovereign wealth so far in 2008.

By Lynann Butkiewicz, Nicholas Pettifer and Tom Young

Largest sovereign wealth funds



Source: Morgan Stanley September 2007

Canada's position

Although Canada has set out its views on foreign state buyers, its guidelines offer insufficient guidance

Canada has officially taken note of the increasing tide of investments through state-owned enterprises (SOEs). On December 7 2007, the Canadian government announced that special guidelines would apply to the review of Canadian investments by SOEs under the Investment Canada Act (ICA), Canada's foreign investment review legislation. In brief, the guidelines define SOEs as enterprises owned or controlled directly or indirectly by a foreign government (which would include sovereign wealth funds). They only apply to SOE investments that are already reviewable under the ICA, and do not prohibit such investments. According to the guidelines, the government will examine adherence to Canadian standards of corporate governance, and will assess whether the SOE will operate the target business according to commercial dictates. The guidelines also offer examples of the types of binding commitments that SOEs may be required to provide. Importantly, they do not single out investments in particular economic sectors, or by particular countries.

Winning approval

The ICA requires that the Minister of Industry approve acquisitions that exceed certain monetary thresholds before closing or in some cases, afterwards, according to whether the deal will yield a "net benefit to Canada". The guidelines go beyond the general factors the Minister will consider in approving a reviewable investment, and focus on issues particular to SOEs. They identify the "governance and commercial orientation of SOEs" as central in assessing whether SOE investments should be approved. The government will examine adherence to Canadian standards of corporate governance – transparency and disclosure, the presence of independent directors, audit committees and the equitable treatment of shareholders, and compliance with Canadian laws and standards. It will also consider how and to what extent the investor is owned or controlled by a state.

The government will also evaluate the SOE's commercial orientation regarding the target business, including: "where to export;

where to process; the participation of Canadians in its operations in Canada and elsewhere; the support of ongoing innovation, research and development; and the appropriate level of capital expenditures to maintain the Canadian business in a globally competitive position." The guidelines also outline the types of binding commitments

“It is unclear whether the government will become more restrictive towards state-owned investment than before”

or undertakings that may be required to ensure that SOE investments benefit Canada. The SOE may have to commit to appointing Canadians as independent directors, employing Canadians in senior management, incorporating the target business in Canada, and listing the shares of the acquiring company or the target Canadian business on a Canadian stock exchange.

Uncovering the motives

The guidelines give insight into the government's concerns about SOEs. But their level of generality is so high that they raise more questions than they answer. For example, they do not indicate what degree of ownership or control is required for an entity to be an SOE. If an SOE is defined in accordance with the ICA nationality of control provision, control may be sufficient. Interestingly, investors controlled by individuals closely linked with a foreign government (including relatives) or by foreign government pension funds might fall outside the definition.

A big concern is that SOEs will pursue political agendas at odds with Canada's national interests. The guidelines do not propose to assess the motives behind investments, but they list factors that might reflect a deviation from commercial principles. For example, the government will consider the destination of exports, reflecting potential concerns that the SOE could buy up resources to fuel its home economy,

rather than supply Canadian customers.

The guidelines address governance concerns by measuring the SOE against Canadian standards. A requirement for independent directors might have the aim of ensuring that the Canadian business is governed by an entity with some directors not from the SOE's home state. However, the home state could view this requirement as unacceptable meddling.

A tepid welcome

Ambiguity also exists concerning what the government means by adherence to Canadian laws and standards. If the SOE does not already conduct business in Canada, will it be held to Canadian envi-

ronmental or labour standards in its home country?

The possible requirement that the target business be listed on a Canadian exchange is of particular interest. This could be seen as indicating that the government might require a minority Canadian shareholding in certain instances. Such a step would be one way for the government to ensure that SOE disclosure meets Canadian securities laws, while at the same time giving Canadians the opportunity to become part owners of the target Canadian business.

SOEs should note that the guidelines' impact is limited to investments already reviewable under the ICA. Investments that do not constitute acquisitions of control (such as small shareholdings), or are below the review thresholds, are not reviewable.

Given the guidelines' lack of precision, it is unclear whether the government will become more restrictive towards state-owned investment than before. To resolve this uncertainty and avoid discouraging SOE investment, it should set up a timely and transparent process for responding to investors' questions, and should communicate results in a way that protects investor confidentiality. Such a process would increase predictability and consistency in investor treatment. Without it, the guidelines may make Canada less welcoming to SOE investors.

By partner Jeff Singer and counsel Sandra Walker at Stikeman Elliott LLP

A complicated victory

The rules that protected VW stock are now illegal. But that doesn't necessarily help shareholders, it just makes everything more complicated

Since Porsche became the largest shareholder of Volkswagen, press attention has focused on the two German carmakers. Two court cases have been particularly prominent. The first referred to the so-called Volkswagen Act: on October 23 2007 the European Court of Justice decided that the Federal Republic of Germany violated European law by maintaining certain provisions of the Volkswagen Act, a decision that will undoubtedly have consequences for Porsche as Volkswagen's largest shareholder. The second court case – decided just one day later, on October 24, by the Labour Court of Stuttgart – dealt with employee co-determination issues within Porsche. It appears to have had no initial effect on Volkswagen, but a knock-on effect may occur when Porsche acquires the remaining shares and increases its participation in Volkswagen to more than 50%. In its most basic terms, the Labour Court of Stuttgart confirmed that Porsche does not have to take care of any issues Volkswagen had in the process of establishing a European Stock Corporation. The background to the European Court of Justice decision, and its implications for Volkswagen, are worth investigating.

The VW Act

After the war, Volkswagen was first controlled by the British High Commission before the company was eventually returned to German hands. It soon became commercially successful. The Volkswagen Act, becoming federal law in 1960, gave special rights to the Federal Republic of Germany, the State of Lower Saxony, and the trade

unions. The voting rights of any shareholder were restricted to 20% as a maximum, regardless of how many shares the shareholder had – a shareholder with 51% of the shares would only have voting rights of a shareholder owning 20%. The Bundesländer of Lower-Saxony and the Federal Republic of Germany were each entitled to send two members to the supervisory board, as long as they were shareholders. The establishment and transfer of production sites required a majority of two-thirds of the members of the supervisory board. The majority requirement for resolutions at the general shareholders' meeting was set at 80%, instead of the standard requirement of 75%. The Volkswagen Act followed a series of discussions between the Federal Republic of Germany, the State of Lower Saxony, and other jurisdictions about the company's ownership. The trade unions had also participated in these discussions, as some of their funds were used by the national socialist regime to build up the components of what later became Volkswagen. It was a compromise to balance ownership interests when Volkswagen GmbH was converted from a limited liability company under German law to the stock corporation Volkswagen AG, today's listed legal entity.

The decision to overturn these provisions will mean that the shareholders' rights will be strengthened. They will be able to influence the company's business in the future – a historic change in the company's policy.

To evaluate the business consequences of the Volkswagen Act for Volkswagen, the basic legal structures of a stock corporation under German law need to be kept in mind. According to German law, a stock corpora-

tion has a management board and a supervisory board. The management board runs the company and represents it externally; the supervisory board supervises and advises the management board. The supervisory board also has the authority to appoint and recall the members of the management board. It will negotiate the details of their employment, including remuneration.

The application of the Volkswagen Act resulted in the following. On the level of the supervisory board, the representatives of majority shareholders will only have a minority position with no decision-making influence. The supervisory board of Volkswagen AG has 20 members. The employees elect 10 members, according to German employee co-determination rules, and shareholders elect the other 10. The two members of the supervisory board appointed by the State of Lower Saxony are deducted from the 10 elected by the shareholders. These two members, along with the employee representatives, account for a clear majority of 12 of the 20 members. Conversely, the remaining shareholders of Volkswagen AG could only elect six to eight members to the supervisory board, depending on whether the Federal Republic of Germany used its special right to appoint two members. Regarding shareholders, a shareholder with 20% of the shares has a right of veto in any general shareholders' meeting against all the other shareholders. Since the State of Lower Saxony owns more than 20% of Volkswagen, it has been in a position to use its veto rights against fundamental corporate changes. It could also prevent attempts to reduce its influence or change the company in a way that would have adverse effects on the economy of Lower Saxony.

All in all, buying shares in Volkswagen AG was highly unattractive for investors in the past. Because of the restrictions of the Volkswagen Act, shareholder rights had no value. Critics argued that the (non-) development of the share price of Volkswagen was a result of the Volkswagen Act.

Golden shares

But the main issue in the public debate about the special rights in the Volkswagen Act was not the influence given to the management of the company through the supervisory board, or the State of Lower Saxony's veto rights in shareholders' meetings, but the restriction of voting rights to 20% of the votes, no matter how many shares a shareholder owned. Such special rights are called golden shares because they are usually associated with the ownership of a special share that grants these rights. With Volkswagen,

“The decision of the European Court of Justice may have no immediate legal consequences”

though, it was originally a governmental law that granted the rights.

On March 4 2005, the European Commission initiated legal action against the Federal Republic of Germany as the body responsible for the Volkswagen Act. The Commission argued that the provisions of the Act infringed on the free movement of capital, and the freedom of establishment guaranteed under the EC. The European Court of Justice took the side of the Commission. Its decision was not unexpected, as Court of Justice decisions on golden share provisions in other member states of the EU also declared them be void.

Given that expectation, it was only a matter of time before investors would begin to show more interest in Volkswagen AG. After all, it is Europe's biggest carmaker, yet it has a rather low share price. Porsche stepped in first, and today is the largest shareholder in Volkswagen AG, owning roughly 31% of the shares. The value of shares both in Porsche and in Volkswagen AG has increased swiftly since then. The markets now expect that Porsche will rapidly increase its share in Volkswagen to more than 50%.

A complicated picture

But from a financial and legal perspective, such an increase of Porsche's participation quota may not make sense, at least at the moment. The shares in Volkswagen AG are still quite expensive. Although Porsche has already bought options for additional shares, it did not exercise those options. Rather, it decided to sell them at a profit of roughly €3.6 billion (\$5.3 billion), according to a recent Porsche press release.

In addition, legal issues could bring the recent increase of Volkswagen share prices into question. Such thoughts may have influenced Porsche's decision not to increase its interest in Volkswagen AG, at least for the time being. Although one would expect that the special rights granted by the Act are no longer valid, it may be possible to argue that legally they still hold. The decision of the European Court of Justice may have no immediate legal consequences. The Court of Justice decided against the Federal Republic of Germany because it did not change an act of federal law after the historic reasons for the law had disappeared. The Federal Republic of Germany as defendant must now change or remove the Volkswagen Act. But the decision is directed neither against Volkswagen AG nor against its shareholders. The Volkswagen Articles of Association, which repeat the respective provisions of the Volkswagen Act, could come into play, since they make it possible to argue that the

special rights have a separate legal basis. As a result, the rights could apply even if the Volkswagen Act itself is no longer valid.

Porsche's problem

On these grounds, one could argue that the special rights granted by the Articles of Association still apply in principle. Presumably, the Court of Justice decision will not automatically result in the immediate or partial ineffectiveness of the provisions of the Articles of Association, because the provisions violate neither the law nor morality. The violation of European law is not necessarily associated with the legal content of the special rights, and such rights are by no means special in business life. What is unusual is that the Federal Republic of Germany itself has granted them to itself and to the State of Lower Saxony.

The Articles of Association are not the result of any law, but of a majority resolution of the shareholders of Volkswagen AG under the German Stock Corporation Act (*Aktiengesetz*). The Federal Republic of Germany is only able to change or terminate the Volkswagen Act by law. It will not be able to change the Articles of Association, as this is a matter for the shareholders, in accord with the Articles of Association and German Corporate Law. So it will not be easy to argue that a decision against the Federal Republic of Germany, as the body responsible for the Volkswagen Act, results in the partial ineffectiveness of a corporate agreement resolved by the shareholders of a public listed company at some point of time.

It should therefore be expected that Porsche, the new majority shareholder, will try to amend the Articles of Association of Volkswagen AG at the next opportunity. Presumably, there will not be an extraordinary shareholders' meeting solely for this purpose because such meetings are lengthy and costly procedures for listed companies. An attempt to amend the Articles of Association may therefore take place at the next annual shareholders' meeting of Volkswagen AG in 2008.

Another aspect of this problem relates to trade unions: the decision of the European Court of Justice did not cover the special rights granted to them – the right of veto in the supervisory board regarding the establishment and transfer of production sites. The works council of Volkswagen AG and the representatives of the trade unions have already argued that the Volkswagen Act should only be amended insofar as it was criticised by the European Court of Justice; this would protect their particular rights. On January 16 2008 the German Secretary for Justice, Brigitte Zypries (a member of

the Social Democratic Party) presented the first draft of the new Volkswagen Act. The Secretary explained that the Act would not be removed completely, but upheld, insofar as it did not contradict European Law. The special rights of the employee representatives on the Supervisory Board would prevail, according to this draft. More surprisingly, the majority requirements for material decisions of the general shareholders' meeting would remain at 80%, because it is argued that the European Court of Justice only rejected the combination of the restriction of voting rights and this majority requirement.

This recent development demonstrates that German politics is far from giving up its influence in Volkswagen without resistance. It may even be possible that the European Commission will challenge the new Volkswagen Act, should the draft be implemented. On the other hand, the new draft could be seen in the light of the upcoming elections in Hesse and, in particular, in Lower Saxony, on January 27 2007.

Given these strong political overtones, Porsche will consider its next steps carefully. As noted above, the State of Lower Saxony owns shares representing about 21% of the votes. It will be interesting to see how the State of Lower Saxony will vote in future shareholders' meetings, should Porsche initiate amendments to the Articles of Association. Notwithstanding any issues with a new Volkswagen Act, there is no guarantee that the State of Lower Saxony would voluntarily vote in favour of the proposed amendments, by which some or all of its special rights, including the veto rights, would be removed. The State of Lower Saxony could buy protection by deciding to increase its share to 25% of all shares. But it could also rely on the traditionally low presence of shareholders at the general shareholders' meetings, as there is a distinction between total votes and votes at those meetings. 21% of all voting rights could grant an actual voting power of more than 25% of the votes in the general shareholders' meeting. As only that is important, the existing voting rights of the State of Lower Saxony could already be sufficient to constitute a veto right that is in accordance with the German Stock Corporation Act.

All this demonstrates that the public perception of the consequences of the European Court of Justice decision may have been premature. Apart from stock price considerations, Porsche will closely watch the next steps that the Federal Republic of Germany and the State of Lower Saxony take.

By Robert Heym, associate at Reed Smith LLP

Contrary views on disclosure

Should holders of contracts for difference have to disclose their positions, even if they have no access to voting rights? The debate is raging at UK and EU level



The FSA's recent consultation paper on the disclosure regime governing contracts for differences highlights market concerns that "hedge funds may outflank traditional institutional investors by using economic interests to influence companies" (CP 07/20 Disclosure of Contracts for Differences). The view that funds holding large contract for difference (CFD) positions may influence management is widely held, particularly among traditional institutional investors. Yet there is no strong legal basis for it, and there is little evidence that CFDs are used for that purpose. So how should issuers deal with CFD holders?

Influence

In the UK, company directors have a duty to "promote the success of the company for the benefit of its members as a whole". A company is not obliged to look beyond its register of shareholders in identifying its members. As long as a company owes a duty to its members, that concept is limited to the legal owners of shares, recorded on the company's register. While directors need to have regard to the interests of stakeholder groups such as employees, there is no need for a company to look after the interests of the world at large. More specifically, a company does not have to take care of the interests of holders of CFDs.

Writers of long CFDs will often hedge their positions by taking an equivalent position in underlying securities. When a holder of a long CFD position can direct how the shares used to hedge the CFD are voted, or require physical settlement of the CFD, one could argue that its interest is akin to an equity interest and that management should recognise this and act on it. In these circumstances, directors may think that the interests of the shares' registered holder (that is, the CFD writer) are effectively the same as the interests of the CFD holder. Indeed, a board may be reluctant to ignore the demands of a CFD holder that controls a large proportion of the company's voting rights.

CFDs can be part of activist or takeover strategies, or attempts to avoid disclosure requirements, but they have other functions too. The stamp duty savings are beneficial. Crucially, CFDs are issued on the basis of up-front margin payments that are much less than the overall value of the position, allowing flexibility on funding and leverage. As the FSA's consultation paper points out, many CFD agreements do not enable the CFD holder to direct voting rights. They are cash settled. The holder has a purely economic and no proprietary interest in the shares underlying the CFD. The FSA's position in assessing changes of control in authorised firms is consistent with this analysis. Although the acquisition of a 10% equity holding in an authorised firm requires FSA approval, the FSA may not count a person's interest in certain CFDs when assessing whether that threshold has been breached. This is a valuable tool for bidders building stakes in an FSA-authorised target before a takeover offer is made. Pearl Assurance used the option recently when building its stake in Resolution. Still, the Takeover Code requirements and the regimes governing price sensitive information should be carefully considered.

When CFDs have no proprietary rights to the underlying shares, it is difficult to see why a board should feel obliged to act on the CFD holder's views – it is not a member and has no right to vote or to become a member. CFD holders often seek to influence management or the outcome of a takeover offer. If the CFD holder pursues an activist strategy, the directors may consider the issues the holder raises to be relevant, and may act on them, regardless of the company's legal obligations to that CFD holder; but that is different from the question of to whom the directors owe their legal duties.

Disclosure obligations

In formulating a response to a CFD holder's approach, a company should consider the extent to which the holder controls voting rights or is able to demand a physical settlement. If a fund manager wants to influence the board, it should incorporate control of voting rights in the CFD.

In the Hedge Fund Working Group's final report in January 2008, it acknowledged that many of its consultees want further discussion in this area. It stated "companies have a right to know who owns them or who has an ability to easily obtain significant voting power." If directors need to know the extent of the CFD holder's voting rights to see what their duties are to that holder, a mechanism should be in place to give them that information.

But because the legal relevance of the CFD holder's interest in a company depends largely on its access to voting rights, the company's knowledge should be limited to information about those with the ability to acquire shares or voting rights as a result of their interest in the CFD. Other holders simply don't own the company in the way that a shareholder does.

Although not expressed in those terms, the FSA's suggested approach, Option 2 in the consultation paper, endorses much of this rationale. Under Option 2, disclosure of a CFD position is not required when the CFD is structured so that the agreement with the writer prevents the holder from exercising or seeking to exercise voting rights; the terms of the agreement exclude further arrangements or understandings regarding the sale of the underlying shares; and the holder explicitly states that it does not intend to use its CFDs to seek access to voting rights.

But Option 2 goes further. It allows issuers to request disclosure of pure economic interests. This would arise when reasonable cause exists for the issuer to seek disclosure, and when the holding exceeds 5% of the economic interests in

“The Takeover Code and the FSA's proposed changes can be reconciled, but at a fundamental level they do not agree”

the issuer (and at 5% levels afterwards in accord with the Transparency Directive, or when an interest fell below those thresholds). This aspect of the proposal is likely to generate tension. Fund managers will be keen to keep their proprietary trading positions confidential when no effort is made to influence management or exercise voting control. On the other hand, issuers may wish to know the identity of the economic owners of their business. The tension is even more acute in the case of the FSA's Option 3: a general disclosure obligation regarding CFDs would be created, even when the position taken is a purely economic one. By contrast, the US imposes a disclosure obligation on CFD holders seeking to exercise voting control or influence management, and requires only limited annual disclosure of pure economic CFDs.

No real agreement

Although the UK City Code on Takeovers and Mergers requires more general disclosure of economic interests in an offer period, that regime differs from the general need for disclosure because, as the Panel has stated, the distinction between those with control over the underlying shares and those who only have an economic interest in their price "is not easily drawn in the context of a takeover". The Panel's rationale for requiring disclosure of CFDs without reference to the CFD holder's economic interest was that:

"To draw a distinction between holders of "controlling CFDs" and holders of "purely economic CFDs", particularly in a market where CFDs are written "over the counter", would be over-simplistic in the context of a takeover where the price of a takeover stock is determined by the outcome or the likely outcome of the bid and where an interest in the price of a takeover stock is therefore an interest in the outcome of the bid."

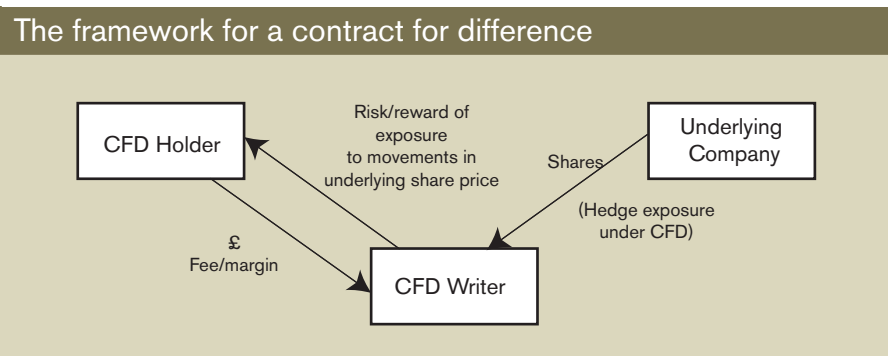
The Takeover Code requirements and the proposed changes to the Disclosure and Transparency Rules can be reconciled, but at a fundamental level they do not agree. The Panel appears to have been willing to look beyond the form of CFD documentation when determining its view of CFD holders' controlling interests in relation to underlying shares.

EU role

Both the FSA and key players such as the Hedge Fund Working Group have acknowledged the need for a public debate about CFDs. CESR has also assessed the need for further consultation and potential harmonisation of regulators' stances on disclosure of derivative positions as part of its review of the implementation of the Transparency Directive. More work on the subject now seems likely at EU level.

It will be interesting to see whether the FSA takes a broader view of CFDs in the same way that the Takeover Panel has done, in this era of principles-based regulation. Fund managers will probably press for disclosure obligations to be limited to those seeking voting control or wishing to influence management. For now, the FSA seems to support a regime based on legal relations consistent with fundamental company law principles and the legal duties that the directors of issuers owe.

By partner Mark Geday and associate Stephen Newby at Herbert Smith. The firm advised the Hedge Fund Working Group on its best practice standards issued in January 2008



We are proud to celebrate innovation

Innovation has become something of a dirty word in 2008. Much of the financial trickery used by banks and their lawyers to construct capital markets offerings has been blamed for the world's economic woes. But the real blame lies with the way those deals were sold, explained and rated. There's nothing wrong with complication per se.

At IFLR we are proud to celebrate innovation. It is not necessarily good, and some products may mask risk with overcomplicated layers of packaged securities or derivatives. But it is not necessarily bad either, and the lawyers that worked on those deals deserve recognition for their hard work and, most of all, their ingenuity.

At IFLR we are also rather proud of our awards. As the only legal award that is transparent and specific with its criteria, the owner of an IFLR trophy can feel he has been rewarded for work well done and objectively judged. Not for some opaque combination of importance, size or simply "having a great year".

Throughout the 11 years they have been running, IFLR has strived to reward genuine legal innovation in European finance. That,

and nothing else. We analyse legal innovation, and nothing else.

Every year one or two firms don't read our criteria correctly, and send us reams of information about how many lawyers they have hired. Some tell us they worked on all of the top five deals last year. One or two protest that their deal had a lot of media coverage. We don't care. IFLR only rewards legal innovation, and to an extent the market impact of that innovation.

This has created consistency. It means that the awards are transparent. The most innovative deals win, and the firms that worked on those innovative deals win. Many awards ceremonies fall short of this transparency. No one really knows why firms win awards. Clients vote for their favourite firms, using whatever criteria they prefer.

Here, we are proud of the analysis our journalists put in every year. People trust our awards, just like they trust our magazine. The research process itself began in November and lasted right up until a few weeks ago. Thank you very much to all those who took the time to help, through providing information and



taking calls from our various journalists.

I wish you all continued success in 2008.

Simon Crompton, IFLR editor

Asia team of the year

Paul Weiss Rifkind Wharton & Garrison



Jeanette Chan and Jack Lange from Paul Weiss Rifkind Wharton & Garrison

Other nominated firms:

Clifford Chance
Freshfields Bruckhaus Deringer
Shearman & Sterling

Paul Weiss Rifkind Wharton & Garrison rode the wave of Asia's private equity success story in 2007.

The firm's highlight was arguably its role in Oaktree Capital's \$1 billion buyout of Fu Sheng in Taiwan. This was the first private equity buyout of a listed company in Taiwan, and acted as a benchmark for other private equity hopefuls. The main obstacles came from the regulators. With Taiwan's Stock Exchange ailing, the FSC worried about private equity investors buying majority stakes and de-listing companies.

Paul Weiss also acted as international counsel for KKR's investment in Tianrui Cement in China. This was a prime example of the recent move to onshore structures in China.

Europe team of the year

Freshfields Bruckhaus Deringer

Other nominated firms:

Allen & Overy
Clifford Chance
Lovells

Freshfields had a major role in two of the IFLR short-listed private equity deals. It advised CVC Capital partners on the sale of its stake in ista International for \$3.2 billion. The Freshfields private equity team also represented Permira in its acquisition of Valentino Fashion and its subsidiary Hugo Boss. This deal effectively created two public-to-private transactions in two jurisdictions (Italy and Germany) under the same deal umbrella

Elsewhere the firm advised Centaurus and Paulsson as major shareholders of Stork in relation to Candover's bid, Cinven on the disposal of Klöckner Pentaplast to an affiliate of The Blackstone Group for €1.3 billion and Investor AB and Morgan Stanley Principal Investments on their €2.85 billion acquisition of Mölnlycke Health Care Group from Apax.



Nick Shrimpton (centre) presents the award to Ludwig Leyendecker and Oliver von Rosenberg from Freshfields (left and right, respectively)

Americas team of the year

Simpson Thacher & Bartlett

Other nominated firms:

Blakes Cassels & Graydon

In its representation of Hilton Hotels when Blackstone acquired the company, the firm took part in a trend of private equity behaving like strategic investors.

Davis Polk & Wardwell

The firm's role representing the target in the Citadel cash investment in E*Trade Financial places the firm under consideration for team of the year.

Osler Hoskin & Harcourt

The firm's role for KKR in its \$29 billion acquisition of First Data helped to reopen a sluggish market.

Schulte Roth & Zabel

It represented Cerberus in the highly talked about acquisition of Chrysler, making one of America's icons the product of a private equity buyout.

Sullivan & Cromwell

Represented the targets on Hilton Hotels and TXU - at \$45 billion, the largest ever US leveraged buyout.



Adele Bonnie of Simpson Thacher receives her award from Simon Crompton

Simpson Thacher & Bartlett won roles on half of the deals shortlisted this year. The practice excelled in its representation of private equity firms in some of the

most significant transactions of the year. It acted for KKR in the First Data and TXU acquisitions. It also advised Blackstone in its acquisition of Hilton.

Asia deal of the year

Oaktree – Fu Sheng



Left to right: Jin Tao from Jun He, Victor Chang of LCS & Partners, Simon Crompton of IFLR, Jack Lange from Paul Weiss Rifkind Wharton & Garrison and Wen-Hsuan Lin of Lee & Li

Following Carlyle's high-profile failed bid for Advanced Semiconductor Engineering, private equity buyouts in Taiwan seemed doomed. The Financial Services Commission (FSC), the country's regulator, was conjuring up new conditions for bids and investors were getting cold feet. But Oaktree's majority buyout of Fu Sheng a golf club manufacturer was a blessing for the sector.

The main obstacles to the deal came from the regulators. The FSC was dealing with a potentially volatile buyout. With Taiwan's Stock Exchange ailing, the regulator worried about private equity investors buying majority stakes and de-listing companies, with the risk of them not re-listing.

As such, the successful buyout represents a milestone in Taiwan. All approvals were firsts and the deal proved that private equity buyouts are possible in Taiwan.

Paul Weiss, arguably lead counsel, was in constant dialogue with the FSC. Jun He Law Offices and Lee & Li acted for Oaktree while Baker & McKenzie advised the shelling shareholders of Fu Sheng. LCS & Partners was sole counsel to Fu Sheng.

Runners-up

CVC – Zhuhai Zhongfu

This deal marks the largest private equity investment to date in tradeable A-shares of a China-listed company. It is also the first control-oriented PIPE (private investment in public equity) deal in China involving a direct investment in tradeable A-shares.

Clifford Chance advised CVC Asia Pacific on its acquisition of a 29% interest in tradeable A-shares in Zhuhai Zhongfu Enterprise. Jun He also advised CVC along with Maples & Calder.

The deal took advantage of laws passed in 2006 that encouraged investors in the A-share market. But these laws were drafted to appeal to trade buyers not private equity investors, with the necessity of a \$500 million net capitalisation in order to qualify – understandably difficult for a company with no draw down.

Central Ministry of Commerce approval was needed and despite being notoriously difficult to achieve, was gained within six months. CVC and Clifford Chance structured the entire deal before approaching the Ministry. Alpha Law Firm represented Zhuhai Zhongfu.

Longreach – EnTie

This deal was the first majority buyout in the rapidly consolidating Taiwanese banking industry. The existing consumer credit problems in the sector, which were compounded by the sub-prime fallout and resulting credit crisis, were overcome.

The transaction was effected through a

“The equity units entitle the holders to part of a royalty stream paid out of IBU's Ebitda”

unique and complex structure that involved the issue of common shares and newly-issued Series 1 Convertible Perpetual Preferred Shares, which are convertible into common shares at a one-to-one ratio. It is also still rare for a (primarily) Japanese fund to pursue a foreign business. It inspired copycat deals, with other Japanese funds showing signs of emulating Longreach's outward-looking business model.

Shearman & Sterling acted as international counsel for Longreach while Debevoise & Plimpton represented Orix, the co-investor. Houthoff Buruma also represented Longreach alongside Tsar & Tsai Law Firm and Maples & Calder. Lexcel Law Offices also advised Orix.

Project Capricorn

This was a \$135 million structured equity-linked private financing for an Indonesian coal mine owned by PT Ilthabi Bara Utama (IBU).

The equity units entitle the holders to part of a royalty stream that will be paid out of IBU's Ebitda and can be exchanged for equity in the unlisted company once the notes expire or automatically converted in the event of an initial public offering.

The deal is tightly structured and investors have been granted full senior secured priority. In addition, IBU can only draw down the funds on a staggered basis, with each drawdown subject to completion of pre-determined milestones.

Milbank represented PT Ilthabi Bara Utama. Latham & Watkins acted for the placement agent.

Warburg Pincus – Titan

This was a dual-layer deal. Warburg Pincus subscribed for three different types of securities in Titan Petrochemicals Group Limited and for two in Titan's subsidiary, Titan Group Investment.

The entire transaction had to be structured around the terms of high-yield notes issued by Titan in 2005 and a complex pre-closing reorganisation had to take place to ensure compliance with the terms of the notes. The transaction also had to be carefully structured around the connected person regime in the Hong Kong Listing Rules and the mandatory offer regime under the Hong Kong Takeovers Code.

Freshfields and Davis Polk & Wardwell advised Warburg Pincus, and played a pivotal role in the structuring of the dual-layer deal. Skadden Arps advised Titan Petrochemicals alongside Conyers Dill & Pearman.

Europe deal of the year

Permira / Valentino



Simon Crompton of IFLR with (L-R) Ian Frost of Freshfields, Martin Geiger of Hengeler Mueller, Andrea De Tomas of Bonelli Erede Papalardo, Christian Cascante of Gleiss Lutz and Peter Goes from Linklaters

Permira's \$1.064 billion acquisition of a controlling stake in Valentino Fashion Group was quickly followed by \$2.919 billion and \$2.212 billion takeover offers for the outstanding shares in Valentino and Hugo Boss (of which Valentino had a controlling stake). This effectively created two public-to-private transactions in two jurisdictions (Italy and Germany) under the same deal umbrella.

This transaction had been praised for its logistical innovation in meeting unique regulatory and timetable requirements and also for the successful negotiations with shareholder families.

Freshfields Bruckhaus Deringer acted as international counsel and Bonelli Erede Pappalardo acted as Italian counsel to Permira. Carey Olsen provided assistance in the Channel Islands. Gleiss Lutz and D'Urso Munari Gatti worked out of Munich and Milan respectively for Valentino, while Studio Legale Gambino advised International Capital Growth on the sale of the original controlling stake. Hengeler Mueller represented Hugo Boss in Frankfurt and Düsseldorf and Linklaters advised the banks.

The runners-up

Apollo / Countrywide

The circumstances surrounding the £1 billion (\$1.99 billion) Apollo acquisition (via incorporated company Castle Bidco) are what make this transaction unique. Only a week before Apollo's recommended scheme of arrangement, 3i had another recommended scheme of arrangement voted down. 3i had just put out a no-increase statement which locked its bid unless another bid came in. Apollo's entrance created a semi-competitive situation.

Apollo's successful bid was also interesting because of the structure of its offer. Countrywide was a public limited company that owned another public limited company (Rightmove – a property website) which is unusual. Apollo had no interest in Rightmove, so it offered cash and shares in the website to persuade Countrywide shareholders to sell. This created many novel drafting solutions.

Ashurst worked for the sellers and Slaughter and May for the purchasers.

Charterhouse / CVC stake in ista

Charterhouse's \$3.2 billion acquisition of CVC Capital Partners' stake in metering business ista International was Germany's largest secondary buyout in 2007. The transaction was structured as a dual-track procedure and the final decision for a share sale was taken very late. It also marked a change in tack for Charterhouse that has focused on UK domestic deals in recent years. Finally, ista has over 40 subsidiaries around the world, but principally in France, Denmark, Spain, the

Netherlands and the United States.

Allen & Overy provided advice to Charterhouse, while Freshfields Bruckhaus Deringer represented CVC Capital Partners. P+P Pöllath + Partners advised the ista management and Shearman & Sterling represented the banks.

KKR / Alliance Boots

This £11.1 billion (\$22.04 billion) deal was important in a number of ways. KKR and Stefano Pessina used AB Acquisitions as a bid vehicle on the recommended takeover of Alliance Boots in the largest leveraged buy-out in Europe. The transaction marked the first private equity takeover of a FTSE 100 company. It was also the first large, completed public takeover in Europe to involve the underwriting of equity by financing banks.

KKR turned to a combination of Clifford Chance and Simpson Thacher & Bartlett for representation. MacFarlanes was hired by Stefano Pessina and Alliance Boots sought advice from Slaughter and May.

“Boots was the first takeover to involve equity underwriting by the financing banks”



Americas deal of the year

KKR/First Data



(L-R): Krystle Fonyonga of IFLR, XXXX, Wilson Neely of Simpson Thacher, Daniel Serota of Sullivan & Cromwell and Donald Mosher of Schulte Roth & Zabel

Kohlberg Kravis Roberts (KKR)'s \$29 billion acquisition of First Data last September was known to revive a stagnated market, and became the template for underwriters that wanted to reconcile their jumbo loan commitments with disappointing market realities. It also helped reopen the market.

First Data was represented by Baker & McKenzie, Schulte Roth & Zabel, Gibson Dunn & Crutcher, Sidley Austin and Blakes Cassels & Graydon. Sullivan & Cromwell also represented the strategic review committee and independent directors of First Data. KKR was represented by Simpson Thacher & Bartlett and Osler Hoskin & Harcourt. Davis Polk & Wardwell acted for the banks as providers of bridge equity commitments to KKR.

The runners-up

Blackstone/Hilton Hotels

Blackstone's \$26 billion purchase of Hilton Hotels last October marked a new trend in private equity: some private equity companies are now behaving more like strategic investors than calculated short-term buyers.

At the time of acquisition, Blackstone was in the hotel Reit (Real Estate Investment Trust) business with properties such as LaQuinta.

Sullivan & Cromwell, Blakes Cassels & Graydon and Blake Dawson represented Hilton Hotels. Simpson Thacher & Bartlett, Osler Hoskin & Harcourt, Mallesons Stephen Jaques and Herbert Smith Gleiss Lutz Stibbe acted for Blackstone.

Cerberus/Chrysler

The August closing of the \$7.4 billion Chrysler sale to Cerberus was the first time an iconic American automaker had been put up for sale to private equity. It was also the last significant private equity transaction to close before the credit crunch at the end of the summer.

Schulte Roth & Zabel represented Cerberus, with Freshfields Bruckhaus Deringer acting as German counsel. Skadden Arps Slate Meagher & Flom and Shearman & Sterling were co-M&A counsel to Daimler. Fasken Martineau DuMoulin was Canadian counsel to Daimler. Hogan & Hartson acted as FCC counsel to Daimler. Creel y García-Cuellar y Múggenberg represented Cerberus. Milbank Tweed Hadley & McCloy

“Some private equity is now behaving like a strategic investor”

acted as structured finance counsel to Cerberus. Jauregui Navarrete y Nader represented DaimlerChrysler Financial Services Mexico.

Citadel/E*Trade Financial

Citadel Investment Group's \$2.5 billion cash investment in E*Trade Financial's asset-backed securities and common stock last November was one of the first to set market value for a portfolio of mortgage-backed securities in the midst of the sub-prime financial crisis.

Lawyers had to adjust to changing markets. The deal had to be consistent with E*Trade's prior debt covenants and accommodate the need for various regulatory approvals relating to control of E*Trade, while avoiding holding company status for Citadel.

Fried Frank Harris Shriver & Jacobson represented the buyer. Davis Polk & Wardwell acted for the target.

Harbinger Capital Partners/Calpine Power Income Fund

In February 2007, Harbinger Capital Partners

completed its \$766 million acquisition of Calpine Power Income Fund. The hostile takeover bid came in the middle of a complex corporate multi-billion dollar restructuring.

Goodmans represented Calpine Canada Power, and McCarthy Tétrault represented the company in Calgary. Stikeman Elliott acted for Harbinger Capital Partners with Milbank Tweed Hadley & McCloy acting as US counsel. Fasken Martineau DuMoulin represented Credit Suisse, and Davis Polk & Wardwell was US counsel. Blakes Cassels & Graydon acted for the fund.

KKR/TXU

KKR completed its \$45 billion acquisition of Texas Pacific Group (TXU) last October, marking the largest US leveraged buyout. Not only was it large, but the deal recognised environmental concerns and cut residential electricity prices. When TXU's stock dropped due to concerns about the risk and vast expenditure of the company's 11 planned coal plants, the private equity firm saw the opportunity to take the undervalued company and change its business strategy.

Sullivan & Cromwell and Cravath Swaine & Moore represented TXU. Simpson Thacher & Bartlett, Hunton & Williams, Vinson & Elkins, Strook & Strook & Lavan, Covington & Burling, Davis Polk & Wardwell, Cleary Gottlieb Steen & Hamilton, McDermott Will & Emery and Dechert advised the consortium. Fried Frank Harris Shriver & Jacobson represented Goldman Sachs.



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Bermuda

Nurturing business

Natasha Scotland and Neil Horner of Attride-Stirling & Woloniecki explain how government regulation supports Bermudian business

As one of the leaders in the offshore world for the establishment of investment funds with a reported estimate of more than 2,200 regulated funds, Bermuda continues to be an attractive option for sophisticated investors. A reliable and comprehensive legislative framework along with a politically stable environment provides some of the reasons for Bermuda's large market share.

Structuring the fund

Perhaps one of the reasons for the continued appeal of Bermuda as a jurisdiction for investment funds is its flexible approach to how these funds are structured. The Bermuda Investment Funds Act 2006 (IFA) defines an investment fund as any arrangement with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements to participate in or receive profits or income from the acquisition, holding, management or disposal of the property, or sums paid out of such profits or income. The Bermuda Monetary Authority (BMA) is the governing body responsible for regulating these investment funds.

The IFA only applies to those funds in which the participants are entitled to have their interests in whatever form (shares, units, and partnership interests) redeemed in accordance with the fund's constitution and prospectus. The price is determined in accordance with the fund's constitution and prospectus and therefore does not apply to closed-ended funds. The structures used to establish investment funds in Bermuda are as follows.

The company

A fund may be established as an exempted company registered under the Bermuda Companies Act 1981, with the incorporation process itself taking an average of only a few days to complete. The Act defines a mutual fund as a company limited by shares, or one with a share capital and incorporated to invest the moneys of its members for their benefit, and with the power to redeem or purchase for cancellation its shares without reducing its authorised share capital and stating in its mem-

orandum that it is a mutual fund. An investment fund can also be organised as an investment company that is a closed-ended fund (that is, a company that is not a mutual fund company).

It is also possible to establish a fund as a segregated accounts company or cell company. The Bermuda Segregated Accounts Companies Act 2000 (SAC Act) introduced a system that permits funds companies, with the consent of the Minister of Finance in Bermuda, to operate segregated accounts with a statutory firewall between each cell.

The unit trust

The IFA defines a unit trust fund as a fund under which the property is held on trust for the participants. This structure, operating like the mutual fund company, takes the form of collective investments constituted under a trust deed. A unit trust does not have separate legal status as a mutual fund company. Investors would essentially contribute funds, which the trustee of the fund would hold on trust. The manager of the fund would hold these funds for the benefit of investors.

The main instrument governing this structure is the trust deed (similar to the bye-laws of the mutual fund company). It will contain information relating to the rights and restrictions attaching to units, the terms on which the units are issued, and the manner of calculating the net asset value of each unit. It also contains the issue price and redemption price of units and the rights and restrictions attaching to the units.

The trustee or manager of the trust would make an offer of units to the investors, and is required to issue and file a prospectus with the Registrar of Companies pursuant to the provisions of the Act. The IFA and related prospectus fund rules must also be adhered to. The prospectus would form part of the application to the BMA to establish the unit trust.

Limited partnerships

Because it is regarded as fiscally transparent in most jurisdictions, limited partnerships are a popular vehicle for international ventures. A partnership is defined under the Bermuda

Partnership Act, 1902 as the relation that exists between persons carrying on a business in common with a view to profit. A Bermuda partnership is not a separate legal entity but rather a relationship between the partners. Bermuda partnerships do have the option of becoming legal persons.

Limited partnerships must have at least one general partner. The limited partners are not liable for the debts of the partnership beyond the amounts they have agreed to contribute to it. The partnership agreement, much like the bye-laws of a mutual fund company, would contain provisions for regulating the partnership. It should therefore also outline the rights and restrictions attaching to partnership interests, the manner of calculating the net asset value of the partnership interests, and the rights and restrictions attaching to such interests.

Market trends

Given Bermuda's leading global position in the insurance and reinsurance industries, it is no surprise that offshore funds that have an insurance focus have found a home in this jurisdiction.

Hedge funds have increasingly provided capital to the Bermuda reinsurance market, particularly in the wake of hurricanes Katrina, Rita and Wilma. The devastating hurricane season in 2005 created a capacity crunch in the world reinsurance market, so the class of 2005 insurance carriers was largely funded by hedge fund capital. Additionally, some hedge funds took a direct involvement in the Bermuda reinsurance market by forming their own licensed Bermuda reinsurers, primarily to write property catastrophe risk and frequently high-level coverage.

The establishment of sidecar vehicles, in which hedge funds have been the primary investors, is another significant development in Bermuda's market structure. A sidecar is a reinsurance company that reinsures one other insurance company. It has many of the attributes of a hedge fund, with the reinsurance contracts equating to the underlying investments and the ceding reinsurers equating to the hedge fund managers. It is an attractive vehicle for the reinsurer, as it provides additional under-writing capacity and fee income without diluting shareholders' equity participation in the reinsurance company.

Bermuda's legislative framework has created a business environment that nurtures and sustains free enterprise supported by informed and appropriate regulation and necessary infrastructure. The flexibility in structures available to investment funds is one of the many attractive features provided by the legislative and regulatory framework. It should enable the jurisdiction to continue to attract sophisticated investors.



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Attend your meetings online

Private equity buyers in Brazil should be aware that shareholders' meetings can now be carried out on the web.

Gyedre Oliveira, Denise Moretti and Ricardo Freoa of Souza, Cescon Avedissian, Barrieu e Flesch assess the system

The vast technological progress of recent years, particularly in virtual communications, has offered a new range of possibilities to Brazilian corporations. Among these is the enforceability of general shareholders' meetings carried out through the internet, a controversial subject under discussion in Brazil. Based on the essential rights of shareholders and the legal principle one-common-share one-vote set forth in the Brazilian Corporations Law, a general meeting must ensure the dissemination of information among shareholders, communication and debate between management and shareholders, as well among shareholders, and the full and efficient exercise of voting rights.

More digitisation

One of the legal requirements in conducting a general meeting in Brazil is the shareholders' physical attendance or the physical attendance of their legal representatives, who must sign the attendance book before the meeting begins and the minutes of the general meeting after it is concluded.

To reach the legal quorum for convening and reaching a decision at the shareholders' meetings of a Brazilian publicly-held corporation, the Brazilian Corporation Law allows management to adopt measures for the appointment of attorneys-in-fact by shareholders through a proxy (proxy voting). This works, provided that the company complies with the following requirements: giving shareholders the necessary information for the due exercise of their voting rights; emphasising and ensuring shareholders' right to vote against management proposals; and sending the proxy voting request to all shareholders whose addresses are kept by the corporation.

As a result, the Brazilian legal system does not allow for a completely virtual shareholders' meeting, carried out exclusively by means of the internet and without the physical attendance of shareholders or their legal rep-

resentatives. Therefore the implementation of a completely virtual shareholders' meeting requires applicable legislation to be amended to allow for the creation of digital corporate books, and to attest shareholders' signatures through digital certification. However, the Brazilian Corporations Law does not bar the use of certain digital instruments in the holding of shareholders' meetings.

One alternative is remote attendance of the shareholders by means of a video transmission in real time through the internet, provided that a sufficient number of shareholders or their legal representatives physically attend the meeting to fulfil the legal quorum. Shareholders participating in the general meeting through the internet may exercise their voting rights, granting a proxy instrument to a person physically present at the meeting. The proxy can be granted through the traditional proxy voting request system or through an electronic proxy voting request. In the electronic proxy voting request, the proxy is granted through a digital certification system provided for in Brazilian law, which allows the issue, authentication and submission of the proxy instrument through the internet.

Voting by proxy

Electronic proxy voting enables shareholders to participate in the shareholders' meeting in real time and to exercise their voting rights during the meeting by submitting to the company the electronic proxy instrument in favour of a person physically present at the meeting. The system will allow shareholders to appoint representatives to attend the meeting without setting forth voting instructions, and to issue, authenticate by digital certification and submit the electronic proxy defining their voting instructions during the online shareholders' meeting.

Although neither the Brazilian Securities and Exchange Commission (*Comissão de Valores Mobiliários, CVM*) nor the Brazilian courts have officially rendered their opinion regarding the effectiveness of the electronic

system, the instrument is a valid and effective legal document according to Brazilian regulations (*Medida Provisória 2,200-2/01*). It is important to note that the required notarisation of the grantor's signature in the proxy instrument can be replaced by digital certification with the same legal effects. However there is a discussion about whether this is legally acceptable in the case of proxies granted offshore by non-Brazilian residents.

In both types of proxy voting, shareholders are obliged to prove their status as shareholders of the company, and their representative's authority, to participate in the general shareholders' meeting. When shareholders' meetings are transmitted over the internet, the shareholders must fulfil this requirement before they can receive the password to access the webcasting and voting system.

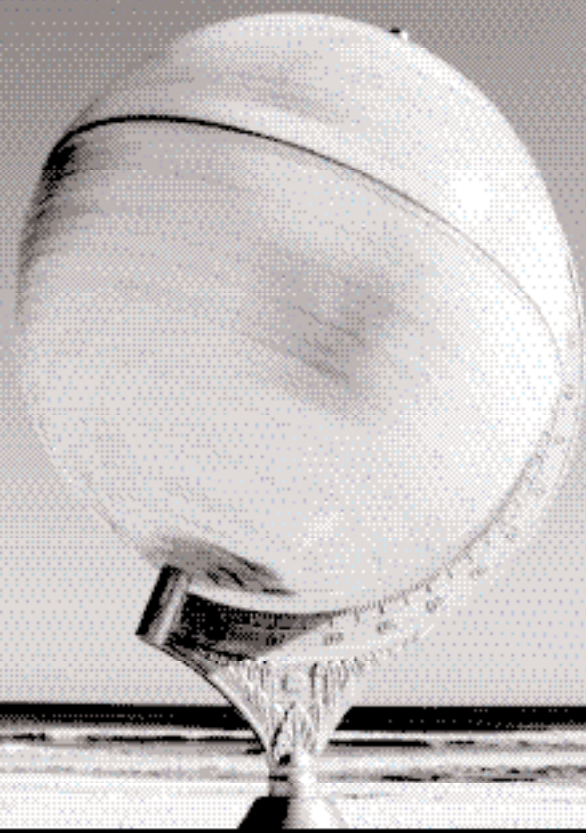
Risks

Corporate practice in other countries demonstrates that online shareholders' meetings may have several advantages. They include a potential decrease of shareholders' costs to participate in general meetings in view of the decrease in geographic distance between the shareholders and the company. Communication among shareholders and company management through the creation of virtual discussion rooms (blogs) is improved. Disclosure levels are better and corporate governance practices are consequently enhanced. Lastly, certainty about the discussions and resolutions taken during the meetings is increased because the event is recorded in its entirety.

On the other hand, the transmission of meetings over the internet and the use of the electronic proxy voting system may make the company vulnerable to certain risks. It is possible that non-shareholders will participate in the meeting. The security level of confidential information disclosed during the meetings may decrease. Wireless connection problems and failure of electronic systems can interrupt the transmission. And delays can occur in time transmission of data. The occurrence of such problems may lead to discussions about the validity and enforceability of votes granted through digital resources and, consequently, on resolutions taken during online meetings.

Brazilian companies should consider the convenience of adopting digital mechanisms to hold shareholders' meetings, taking into consideration the mechanism's effectiveness and the essential rights of shareholders. By doing so, companies will maximise the functions of shareholders' meetings as forums for discussion, provision of information and exercise of shareholder voting rights.

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The needs of the BRIC markets

Offshore structures have a role to play in emerging markets and BVI legislation facilitates them. But their very popularity means that this may be a good time for dialogue according to Leonard A Birmingham, partner at Harneys

In recent times there has been much discussion about the BRIC economies – Brazil, Russia, India and China, in some cases referred to as TRIC where Turkey replaces Brazil. That semantic aside, venture capital in such contexts requires a structure that answers the constraints of their evolving corporate environment. In several of the emerging markets, the commercial environment as a whole and company law in particular tends to be more restrictive than that of more developed economies, and private equity transactions require flexibility. How can offshore structures assist in this environment? They must achieve two things. They must create a more flexible corporate environment for getting funds into or out of a vehicle and in structuring the rights of the shareholders into different classes of shares but with few constraints on what form that structure takes. They must also be able to address corporate governance issues as robustly or lightly as the shareholders see fit.

A relatively common structure involves a British Virgin Islands (BVI) holding company, a Cyprus or Mauritius intermediary and an operating company in the onshore jurisdiction. One example is the TNK-BP Limited structure. From an investor's perspective, the main areas in which BVI law

“Semantics aside, venture capital in such contexts requires a structure that answers the constraints of their evolving corporate environment”

demonstrates its ability to address the limitations mentioned above are in making a range of vehicles available, with wide objects and powers. Furthermore, BVI law provides flexibility regarding the structuring of share classes and issuing shares and share transfers, distributions, financial assistance, corporate governance, and security over shares and suitability for equity capital markets.

Seven different types of company may be formed – companies limited by shares, those limited by guarantee that are not authorised to issue shares, those limited by guarantee that are authorised to issue shares, unlimited liability companies that are not authorised to issue shares, unlimited liability companies that are authorised to issue shares, restricted purpose companies and segregated portfolio companies. For corporate and finance transactions of all kinds including IPO's, joint ventures, securitisations, tax and estate planning and investment funds, the result is increased flexibility and scope.

Objects and powers et al

In the BVI, the effect of the doctrine of *ultra vires* has been reduced in scope and intensity – companies incorporated under The BVI Business Companies Act are not required to specify their objects or powers in their memorandum, their articles or anywhere else. They have full capacity to carry on or undertake any business or activity (irrespective of corporate benefit), conduct any act or enter into any transaction. However, it is possible to restrict the types of business a company formed under the Act may carry out. This will assist parties seeking to form bankruptcy-remote vehicles for securitisations and other similar special purpose companies. The Act also gives companies full rights, powers and privileges in entering into transactions. Transactions entered into by companies incorporated under the Act are not invalid by reason only that the company lacks capacity. Except in relation to charges registered in the Register of Registered Charges (for registering a security interest

created by a company under the Act and kept by the Registrar of Corporate Affairs), constructive notice and knowledge of documents, including the company's memorandum and articles, filed at the Registry of Corporate Affairs or available for inspection at a company's registered office, are abolished.

A company incorporated under the Act has the power to give financial assistance to any person in connection with the acquisition of its own shares. Several jurisdictions still use what is known as a white-wash procedure, which addresses the issue to some extent. But BVI statute obviates the need to consider this issue at all.

There is no concept of “authorised capital” or “share capital” under the Act. Shares are effectively no par value shares. They now represent an entitlement to vote or dividends or surplus assets on liquidation, rather than a fractional part of the capital of the company. The Act requires a company to state in its memorandum the maximum number of shares that it is authorised to issue, the classes of shares that it is authorised to issue, and where there are two or more classes, then the rights attaching to each class. Beyond this, the rights of the shares can be structured as the shareholders see fit. Shares can be issued for any amount of consideration and for almost any form of real or personal property. In addition, share transfers can be subject to as many or as few restrictions as thought appropriate.

A distribution by the company to a shareholder must be made (subject to certain exceptions), only after the directors of the company have satisfied themselves on reasonable grounds that the company will meet the statutory solvency test immediately after the distribution. A company satisfies the solvency test if the value of its assets exceeds its liabilities, and it is able to pay its debts as they fall due. The provisions in the Act relate not merely to dividends but catch any distribution to a member. There are no further constraints on paying dividends or redeeming shares.

Redemption, purchase and acquisition

Similarly, when shares are redeemed, purchased or otherwise acquired, either under the statutory regime under the Act or, as permitted by the Act, under the company's memorandum and articles, the directors must satisfy themselves on reasonable grounds that the company will meet the solvency test for distributions in this context. The company satisfies the test as mentioned above. The ability to redeem shares in accordance with the company's constitution to

the exclusion of the statutory regime means flexibility. It will be attractive to promoters of and investors in open or closed-ended investment funds.

Corporate governance and directors' duties

In keeping with most common law jurisdictions, directors manage the business and affairs of the company. BVI law permits that position to be "subject to any modifications or limitations in the memorandum or articles". The ability to give the shareholders as much or as little control over the affairs of the company as is desired is an established feature of private equity (in particular venture capital) structures. To complement this there are a wide range of statutory devices, in addition to the common law, that protect shareholders.

In addition to the need to act honestly and in good faith with a view to the best interests of the company, directors have a duty of skill and care which, under the Act, has been given a statutory basis. Furthermore, in a departure from the common law position, the Act recognises the commercial realities of joint ventures, holding company and similar structures, and has created provisions that permit a director of a wholly-owned subsidiary to act in the interests of its holding company even if not in the

“The ability to redeem shares in accordance with the company’s constitution means flexibility. It will be attractive to promoters of and investors in open or closed-ended investment funds”

best interests of the subsidiary. When the subsidiary is not wholly-owned but all shareholders (except the holding company) agree, the director may similarly act in the interests of the holding company. Finally, in the context of a joint venture, a director may act in the interests of a member or members even if not in the best interests of the company. The above only applies if the memorandum and articles expressly permit it.

Listings

No stock exchange or securities laws exist in the BVI. There is also no equivalent of the City Code on Takeovers (UK). The result is that most BVI companies listed on metropolitan stock exchanges merely need to comply with the requirements of the exchange on which they will be listed and the requirements of BVI company law under the Act, and common law. The flexibility of

the BVI vehicle is evident from the fact that while there is no equivalent City Code in the BVI, many BVI companies have successfully adopted aspects of the Code into their memorandum and articles.

That offshore structures have a meaningful role to play in emerging markets is self-evident. They facilitate transactions that would otherwise be difficult to consummate and thus keep commerce going. But their usefulness and popularity may be seen as a threat by emerging markets, which tend to be restrictive. So as to avoid a reaction, which potentially stifles the growth of capital markets, a dialogue between small offshore jurisdictions and the aforementioned emerging markets is needed to arrive at a middle ground.

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Partnership rules

Cayman Islands exempted limited partnerships are popular. Iain McMurdo of Maples and Calder explains how to draft them

The last five to 10 years have witnessed the globalisation of the private equity market. In particular US LBO private equity houses have spread their network to Europe, Asia and the emerging markets in pursuit of value driven deals. As a result of this globalisation, the Cayman Islands exempted limited partnership has become increasingly popular as the vehicle of choice for co-investment funds, parallel funds and alternative investment vehicles (AIVs). Indeed, it is also growing in popularity as a vehicle for main funds, when managers and tax advisers have determined that real estate deals, which would otherwise give rise to Foreign Investment Real Property Tax Act (FIRPTA) issues, are unlikely to occur.

When a US Fund forms either an AIV or a Co-investment Fund for certain tax-exempt or foreign investors, the US and Cayman Islands counsel are eager to ensure that the partnership agreement for the Cayman Islands exempted limited partnership mirrors the terms of the Delaware limited partnership used as the principal onshore fund vehicle as far as is possible. Not only must the commercial terms be replicated in the Cayman Islands law governed partnership agreement; the legal protection offered to limited partners, general partner and persons sitting on the Advisory Board, must be consistent with the Delaware limited partnership.

The Cayman Islands laws applicable to exempted limited partnerships comprise the Exempted Limited Partnership Law (2007 Revision) ('the Law') and the rules of equity and of common law applicable to partnerships as modified by the Partnership Law (2002 Revision), except when they are inconsistent with the express provisions of the Law. This regime provides a flexible framework for drafting partnership agreements. Partners may agree by contract how to conduct the partnership subject to certain statutory limitations and common law principles applicable to contractual relations generally and partnerships in particular. Consequently, it is relatively straightforward to adapt the Delaware or any other onshore partnership agreement and to produce a Cayman Islands partnership agreement consistent in all material terms.

Third party beneficiary rights

In contrast with the Delaware regime, US

counsel should note that no third party beneficiary rights extend to persons who are not parties to a partnership agreement governed by Cayman Islands law. This may affect the business deal unless it is covered contractually by other means. Areas to consider will include the claw-back provisions and the requirement to bind principals of the Cayman Islands general partner entity that would otherwise have no obligation to contribute capital if the general partner entity were insolvent. This can be cured separately by contract or claw-back guarantee granted by the principals.

Indemnity provisions are another area to consider. Individuals not party to the partnership agreement may not have a directly enforceable right of indemnity. This is often considered by general partners and members of the Advisory Board and can be managed by separate contracts for each individual concerned or by an indemnity agreement governed by US law, which respects the rights of third party beneficiaries. Additional language in the partnership agreement should also be considered to expressly allow the general partner to enter into these types of arrangements with third parties.

Limited partner interests

Unlike the Delaware regime, limited partnership interests cannot be assigned without the general partner's prior written consent. In practice, the terms of the Delaware partnership agreement often set out certain types of transfers that can be made without the consent of the general partner but with all other transfers requiring the consent of the general partner. Under section 7(7) of the Law, the general partner's prior written consent is required for a transfer of a partnership interest. The general partner may withhold consent, regardless of contrary statements in the partnership agreement. Accordingly, language with respect to certain transfers not requiring the consent of the general partner would be unenforceable and should be amended to ensure compliance with the Law. The general partner may deal with this issue by issuing a comfort letter giving consent to certain types of future transfers. The wording of such letters always requires careful consideration. The parties must ensure that the grant of the comfort letter constitutes a proper exercise of the general partner's powers.

Powers of attorney

Powers of attorney are commonplace in partnership agreements and are often irrevocable in nature. Under the Powers of Attorney Law (1996 Revision) of the Cayman Islands, a document creating a power of attorney must be executed as a deed (and witnessed, in the case of individuals) or as an instrument under seal by the donor of the power. Section 4 of the Powers of Attorney Law provides that when a power of attorney is irrevocable and secures a proprietary interest of the donee of the power, or secures the performance of an obligation owed to the donee, then the power shall not be revoked by the donor without the donee's consent, as long as the donee has that interest or the obligation remains undischarged. Nor will the power be revoked by donor's death, incapacity or bankruptcy, or (if the donor is a corporate) by its winding-up or dissolution.

To fall within these provisions the powers of attorney must be carefully drafted in the partnership agreement. Sometimes the power of attorney is replicated in the subscription agreement or a side letter, which is governed by US state law, since under certain state laws there is no requirement for the donee of the power of attorney to have a proprietary interest for that power of attorney to be irrevocable.

Rights of withdrawal

In certain circumstances, limited partners have a limited right to withdraw partially or completely from a Delaware limited partnership, if ERISA, anti-trust or other onshore regulations apply, limiting the percentage of ownership a limited partner may hold in certain portfolio acquisitions made by the limited partnership. Typically, these are drafted to allow the limited partner the right to request withdrawal, subject to the general partner's satisfaction of certain conditions, although in some circumstances the limited partner may have a right of withdrawal. Usually the existence of conditions to the right to withdraw will mean the partnership will fall outside the definition of a mutual fund under the Mutual Funds Law (2007 Revision) of the Cayman Islands and will not give rise to regulation by the Cayman Islands Monetary Authority as a mutual fund. However, the partnership agreement must be carefully drafted to ensure the partnership does not need to be registered in the Cayman Islands. This issue can be avoided by ensuring that the general partner retains ultimate control over the withdrawal of the limited partner.

This is part one of a series of articles intended to highlight, in brief detail, the principal points to focus on when drafting the Cayman Islands law-governed partnership agreement in terms that replicate an existing Delaware limited partnership

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A new set of rules

Jens Hörmann and Dr Frank Thiäner of P+P Pöllath + Partners argue that a new Act will change German M&A. But it may not go far enough

The German government plans a comprehensive reform of German corporate law, which will have a significant impact on M&A transactions involving German companies with limited liability. On May 23 2007, the government published its draft Act for the Modernisation of the Law governing Private Companies with Limited Liability and the Prevention of Abuse (Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Mißbräuchen, MoMiG). The Act addresses several issues that have arisen as a consequence of the jurisdiction of the European Court of Justice and the German Federal Court of Justice since the last comprehensive reform of legislation on private limited companies in 1980. The reform will have a significant impact on M&A transactions in Germany.

Minimum share capital

The Act proposes to reduce the minimum registered share capital of a private limited company (*GmbH*) from €25,000 (\$39,500) to €10,000. The proposal follows discussions about the advantages of foreign entities, in particular of English private com-

panies limited by shares which became popular in Germany after the *Centros* and *Inspire Art* jurisdiction of the European Court of Justice, because they promise shareholders limited liability for an investment of only £1. Pursuant to the Act, a German private company with limited liability may be established with a share capital of €10,000, of which only €5,000 must be paid immediately; the remainder must be paid only on request of the company.

Flexibility

Investors in Germany have often complained that shares in German private limited companies follow their own set of rules. Each share in a German private limited company must have a nominal value of at least €100 and the nominal value of each share must be divisible by 50. Also, each shareholder may only subscribe for one share at a time when the company is established or if the share capital is increased. Shareholders may split shares only in connection with a share transfer and only if the nominal value of each resulting share is at least €100 and divisible by 50. Purchasers too can only acquire one part of a share at a time. Finally, shares in private limited companies can only be transferred by way of notarial deed. If any of these rules is disregarded, the denomination of the share capital and any acquisition of shares are void.

The Act proposes to change the situation. Shareholders shall be free to determine the nominal value of their shares as long as the denomination of the shares is in full euros and not less than €1. Limitations regarding the subscription, split and transfer of shares shall be abolished. Shares in private limited companies shall be freely transferrable by their owners. Any transfer of shares, however, will still require the notarisation of the transfer deed so that a certain degree of shareholder protection is guaranteed.

Acquiring shares from non-shareholders

Under the current regime, an investor has to

“Investors in Germany have often complained that shares in German private limited companies follow their own set of rules”

verify the chain of title to the shares from the foundation of the company to the seller, to find out whether or not the seller is the legal owner of the shares. An acquisition of shares in good faith (that is, from someone who is not the legal owner) is impossible. There is no share register on which the investor could rely. The current shareholders' list, which is filed with the commercial registry by the directors of the company, is only declarative and of no legal relevance. A comprehensive due diligence exercise regarding the legal ownership of the shares is required in each transaction. However, even if potential buyers find a chain of title to the seller, they have no guarantee that sellers are the legal owners of the shares because the sellers (or previous owners) may have secretly transferred the shares to a third party.

The Act will improve this situation by increasing the legal relevance of the shareholders' list. An acquisition in good faith shall be possible, as long as the seller has been registered in the shareholders' list as the owner of the shares for the previous three years or more, and no objection has been filed. If it later emerges that the seller was not the owner of the shares, the purchaser will have acquired the title to the shares and the real owner will have nonetheless lost his title.

To improve the quality of the shareholders' list, any German notary public that records share transfers will have to file an updated list of shareholders with the commercial register immediately after the recording, together with a certificate confirming that they have recorded the transfer deed, that all other details of the new list are identical with the old list, and that, based on the documents which the notary has inspected, they have no reason to believe that the new list is incorrect. However, a degree of uncertainty remains. First, the directors of a company may also

update the list of shareholders if a change in ownership takes place other than by way of share transfer deed – for example, if shares are inherited or ownership has passed by way of accretion (*Anwachsung*) of assets to a new owner – or if the share transfer deed has been executed in a foreign country. Second, a purchaser may not rely on the list if the seller has been registered as a shareholder for less than three years. Finally, it is still unclear whether purchasers may only rely on the authority of the registered owners to sell shares or if they may also rely on the fact that the shares exist as they are registered. As indicated, the proposed concept of a bona fide acquisition of shares from someone who is not the legal owner remains to be improved by the government.

The legal relevance of the shareholders' list may also cause some technical difficulties when closing a transaction. Pursuant to the Act, shareholders may only exercise their rights as shareholders (for example, pass shareholders' resolutions) if they are registered in the shareholders' list and if the commercial register published this list. A

shareholders' resolution passed by an unregistered shareholder will only become effective retroactively upon publication of the updated shareholders' list. It may therefore become good practice to agree with sellers of shares that they pass certain shareholders' resolutions (for example, for the appointment of managing directors) on behalf of purchasers. A purchaser will have to indemnify the seller accordingly.

Cash pooling

The Act will also introduce a legal basis for cash pooling arrangements. In 2003, the Federal Court of Justice decided that a private limited company could grant upstream loans only if it has sufficient free reserves or profit carried forward. This should apply even if the claim against the parent company for repayment of the loan was fully valuable. The ruling of the Federal Court led to a high degree of uncertainty about whether or not private limited companies may participate in cash pooling arrangements with other group companies. The Act now proposes to allow upstream loans irrespective of any free reserves or profit carried

forward, if the claim for repayment is fully valuable.

Upstream securities

Unfortunately, the Act does not address the problem of upstream securities. The ruling of the Federal Court of Justice in 2003 left the extent to which a private limited company may grant upstream securities for obligations of its parent company unclear. This is particularly important in private equity transactions where the target group normally grants security (for example, by pledge of its assets and receivables) for the acquisition finance of the purchaser. Even if a pledge of assets or receivables does not reduce their value, the granting of a pledge is comparable with an upstream loan. It has been agreed that upstream securities may only be granted to the extent that they are covered by the company's free reserves and profit carried forward. It can now be assumed that under the new legislation, subsidiaries may grant securities for the obligations of their parent, if and to the extent that their claim for release against the parent is fully valuable.



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Success for SICARs and SIFs

The growth of specialised funds for sophisticated investors confirm Luxembourg's position as a centre of innovation, says Marc Meyers of Loyens & Loeff

A telling number

Six hundred and thirty-eight SIFs were registered as at the end of March 2008. This means that more than 400 new SIFs were created since the enactment of the law of February 13 2007 relating to specialised investment funds (the SIF Law). This is in addition to the institutional funds existing under the earlier regime, which were automatically converted into SIFs

Thanks to its light regulation, operational flexibility and tax efficiency, the SIF has established itself as the reference onshore fund vehicle for sophisticated investors – those that are institutional, professional and well-informed. A SIF is not limited regarding investment policy or strategy. It starts with the more traditional long only investment strategy, and includes hedge funds, private equity funds or property funds; it also covers funds for arts or commodities. Taking advantage of the possibility to set up a SIF as an umbrella with one or more sub-funds (compartments/protected cells) the SIF regime offers well-known operational efficiencies.

With speed-to-market playing an ever increasing role, a SIF may in principle be launched before obtaining its regulatory registration. The application for approval shall be filed with the CSSF within one month of the SIF's launch.

While the SIF regime has become an international reference for European or global property funds, a significant number of SIFs also invest in primary and

“Although the enactment of the SIF Law triggered questions about the relevance of the SICAR regime, the two regimes now thrive side by side”

secondary direct and indirect private equity transactions.

A dedicated PE vehicle

The number of authorised SICARs stood at 191 as at mid-April 2008, with many more in the process of being reviewed by the CSSF.

Although the enactment of the SIF regime may have triggered questions about the relevance of the SICAR regime when compared with the highly successful SIF regime, the two regimes now thrive side by side.

The SICAR is a dedicated private equity and venture capital investment company. The SICAR law characterises risk capital along the following lines:

medium- to long-term (mostly illiquid) investment, a development, added value or turn-around strategy in respect of the target businesses, and an exit plan over the medium- to long-term.

Next to the more traditional leveraged buyouts and other private equity transactions, venture capital investment policies are gaining further ground in the context of renewable energies and related technologies.

After almost four years in existence, the SICAR regime is set to be overhauled for the first time. A bill is pending that will modernise the SICAR regime. The most important change will be the introduction of compartments or protected cells for SICARs. This will allow initiators to combine investment strategies and policies in one legal entity, with the benefit of ring-fencing. The SICAR will also no longer be required to publish a net asset value with a pre-set reporting frequency. A series of other amendments, including a change to the role of the Luxembourg custodian bank (in that it will no longer need to verify the regularity of certain operations) will make the regime even more flexible.

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“Thanks to its light regulation, operational flexibility and tax efficiency, the SIF has established itself as the reference on-shore fund vehicle for investors”

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Paradigm shifts in PE law

Private equity investment has always been complex. Lawyers from Kuri Breña, Sanchez Ugarte y Aznar explain why Investment Stock Corporations are better than the traditional tailored solutions

The Mexican Securities Market Law regulates a type of corporation called Investment Stock Corporations (*Sociedades Anónimas Promotoras de Inversión*, SAPI). This corporate vehicle has significant differences from the stock corporations contemplated under the General Law of Commercial Companies (the Corporations Law).

One of the main purposes of the Securities Law is to promote the access of smaller companies to the equity and securities markets. SAPIs have proven to be an ideal vehicle for solving perhaps the most significant legal obstacles confronting private equity investors in Mexico under the traditional corporation structure. Such obstacles include: (i) special or designed corporate governance rights, (ii) transfer restrictions, exit rights and liquidity schemes, and (iii) capitalisation and distributions.

Corporate governance

Prior to SAPIs, the vehicle most commonly used to address certain corporate governance concerns for private equity investors was the trust. Nevertheless, this vehicle has several complications.

Instructions

For the satisfactory operation of a trust, instructions need to be constantly given to the trustee by shareholders. Such instructions must relate clearly to the matters expressly provided for in the trust agreement, otherwise the trustee will not take any action that would require shareholders' judgment or interpretation.

Cost

The establishment of a trust implies fees and costs involved in its set-up and maintenance. Such fees increase the overall cost of the transaction.

Exit rights

In private equity transactions exit rights are one of the most important issues. Private equity transactions need to have a simple and efficient exit right (liquidity scheme).

Under the current Corporations Law, the consent of the shareholders is needed in order for the exit rights and liquidity mechanisms to be implemented. Investors require shareholder consent or alternatively the incorporation of a trust. In the case of incorporation of a trust, the trustee would need to hold the title to the shares of the target company, and instructions would be required by the shareholders for the trustee to implement call options, drag-along, tag-along and other liquidity provisions to which the parties previously agreed.

In addition to the issues of cost and instructions mentioned above, acting on this type of arrangement requires the agreement and cooperation of the relevant trustee.

Capitalisation and distributions

The Corporations Law does not provide a structure for complex capitalisation mechanisms. Therefore the following obstacles usually arise in private equity transactions: (i) shareholders may not waive pre-emptive rights to subscribe capital stock increases in advance, and shareholder consent is required for the issuance of new shares and capital increase or decrease; (ii) corporations (which are not public) may not repurchase their own stock; and (iii) a shareholder may not be excluded from profit distributions.

The obstacles mentioned above have traditionally been dealt with using certain alternatives. In most cases such alternatives are not tailor-made and therefore have limitations, such as:

- Issuing new shares as treasury shares, which are issued at closing. The shareholders subscribe and pay for the

treasury shares, subject to certain conditioned subscription rights. However, in this approach everything must be agreed at closing, thus limiting flexibility.

- The preferred distribution of profits to a particular shareholder is commonly tackled by granting preferred dividends and liquidation premiums through the issuance of preferred shares. The Corporations Law has limited regulations on this matter.

SAPIs

Under the Securities Law the SAPIs have addressed these issues by permitting the adoption of the following provisions in SAPI by-laws, and if needed, further regulating such agreements in a shareholders' agreement.

- Regulating options and other type of buy or sell agreements (for example, rights of first refusal, tag-along rights, drag along rights).
- Entering into other transactions regarding the exercise of pre-emptive rights.
- Granting shareholders the right to withdraw from the company or giving them the right to redeem shares establishing either a specific price or the basis for determined price.
- Establishing restrictions on the transfer of shares or on the transfer of certain rights over shares.
- Providing the rules for the exclusion of shareholders.
- Limiting voting rights of shareholders and/or allowing the issuance of special classes or series of shares, for example (i) non-voting or limited voting rights, (ii) non-economic rights other than voting rights, or only voting rights, or (iv) shares that grant veto rights or special voting rights.
- Deadlock mechanisms.

Recent experiences

In recent transactions SAPIs have been incorporated or traditional corporations have been transformed into SAPIs to adequately tackle the problems and issues discussed above. Some of the benefits of using a SAPI in private equity transactions or other investment structures are flexibility of the investment structures, simple and efficient exit rights (liquidity schemes), and cost efficient structures. Common problems of private equity may be addressed and mitigated using solutions that investors are accustomed to in their practice. Such issues are tackled using provisions already contemplated in the statute instead of preparing tailor-made solutions that would have to be tested.

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Undervalued service

Can third party expert valuations be challenged? David Wallis, Andrew Harrow and Anna Cope of Dechert LLP investigate

A recent case, *Doughty Hanson & Co Limited v Bruce Patrick Roe and Bruce Patrick Roe v (1) Doughty Hanson & Co Limited (2) Nigel Edward Doughty (3) Richard Peter Hanson* considered whether an expert valuation could be challenged due to an alleged mistake by the valuation expert in the matters taken into account in their valuation. At stake was a significant valuation difference – the valuation expert valued Roe’s shares at £9.3 million (\$18.8 million), whereas Roe valued his shares at approximately £100 million.

The case centred on a fund management company, Doughty Hanson & Co, (the company) and a dispute between its three shareholders Roe (Roe) and Hanson and Doughty (the continuing shareholders) over the leaving and valuation provisions contained in the company’s articles of association (articles).

Fair value

The articles provided for a crucial difference in approach if a shareholder was a voluntary seller or a compulsory seller (as a result of no longer being employed by the company). If the shareholder was a voluntary seller, he could serve a transfer notice under the articles specifying a price that he would wish to sell at. If that price was not agreed and the continu-

ing shareholders wished to purchase those shares, the price would be set at a fair value by reference to a valuation carried out by an expert valuer (the valuer). But if the voluntary seller did not like the price set by the valuer, then he could withdraw his transfer notice.

On the other hand, if the selling shareholder was a compulsory seller, then the price for the shares would be their fair value as determined by the valuer. But crucially, there was no corresponding right for the compulsory seller to withdraw his transfer notice if he did not like the price set by the valuer.

Roe resigned as a director of the company triggering an obligation to serve a transfer notice in respect of his shares under the articles as a compulsory seller. However, his transfer notice contained both a fixed price proposed by Roe for his shares and, failing agreement on his proposed price, a requirement that the fair value of his shares be determined by the valuer. When confronted with this hybrid transfer notice, the company treated it as a transfer notice served by a compulsory seller by ignoring the proposed price offered by Roe and instead forwarded just the offer to sell at the fair value to the continuing shareholders. The continuing shareholders accepted the offer to have the price determined by a third party and PriceWaterhouseCoopers (PwC) were appointed by the company as the expert valuer. The articles provided that the valuer would act as expert and not arbitrator but did not require the valuer to state his reasons.

Key uncertainty

In their engagement letter PwC confirmed that the parties would be entitled to make submissions and would be given an opportunity to check the factual accuracy of the information PwC were relying on.

During the valuation process, the company brought PwC’s attention to a key uncertainty; being its dependence on the continuing shareholders remaining with the company. Consequently, PwC included in its valuation methodology the hypotheses that the continuing shareholders were no longer involved in the company and that the company had run its course.

PwC gave the parties an opportunity to comment on their valuation and distributed a draft memorandum setting out their valuation methodology. Roe argued that PwC’s valuation of an entity in which the continuing shareholders were not participating meant that PwC were valuing a fictional entity materially different from the company as at the valuation date (or subsequently). Further, Roe argued that there was no reason to believe that Doughty and Hanson would terminate their involvement with the company at any time in the foreseeable future.

PwC nevertheless issued their valuation certificate using the valuation methodology they had set out in their draft memorandum, resulting in a determination by PwC that the fair value of Roe’s shares was £9.3 million.

Roe sought to challenge PwC’s valuation on the basis that PwC had materially departed from their instructions in effectively valuing “shares in an entirely different (and fictional) entity, i.e. one in which Messrs Doughty and Hanson are no longer shareholders and are no longer participating in the business” as this bore no resemblance to the situation at the valuation date (or subsequently).

Roe’s attack on the valuation failed. The judge held that even though the evidence received by PwC was that the continuing shareholders were not in fact going to leave the company, the fact that they had hypothesised that they would leave did not make the valuation invalid. The judge did not agree that as a result something different had been valued. In his view: “All that it means is that the right thing has been valued but on an erroneous hypothesis. Such an erroneous hypothesis is a mistake, which a valuer, acting as an expert, is ‘entitled’ to make.”

Specific direction

The case underlines the care required when drafting provisions in articles and shareholders agreements requiring a third party expert to be engaged to provide a valuation. At a minimum, careful consideration should be given as to whether it is desirable to be prescriptive about the method of valuation and the factors a valuer should, or should not, take into account when preparing that valuation. Additionally, the parties may wish to give specific direction as to whether a valuer should be subject to any guidelines and/or constraints when formulating a valuation and whether or not the valuer is required to give reasons for his final decision.

For instance, if instead, the articles had simply provided for the fair value of the company ‘as a going concern’, then it is likely that there would have been a very different result and those four additional words could have been worth several million pounds each.

“The Risk Limitation Act introduces a number of steps to prevent undesirable developments in private equity”