German Takeover Law and Practice ③
The Reality of German Takeover Law and Practice
(Interview with German M&A lawyers)

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[Introduction]

This is the transcript of an interview with German M&A lawyers regarding the “Reality of Takeovers in Germany.” Dr. von Falkenhausen is one of the most knowledgeable lawyers with extensive experience in German takeover deals. Dr. Kocher is a lawyer also knowledgeable in the theory and practice of takeover deals. Both are also active in publishing research papers. The interview was held on March 2010, at the conference room of Latham & Watkins LLP, Hamburg office, located near Außenalster and the Max Planck Institute for Comparative and International Private Law. /(Watanabe)

[Contents]

1. Distinction between mandatory offers and voluntary offers
2. Reality of the exemption from a mandatory offer
3. Conditions to be allowed for a mandatory offer
4. BaFin and UK Takeover Panel
5. The case of Porsche/Volkswagen and cash confirmation
6. Rules for competing offers
7. Equity derivatives and “hidden ownership”
8. Issues on the disclosure of the real beneficiary of a takeover bid
9. Workers’ influence and the offer price
10. The case of Schaeffler/Continental and change of control clauses
11. “Unternehmensinteresse” (fiduciary duties of the management)
12. Co-determination and the role of the supervisory board

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1. Distinction between mandatory offers and voluntary offers

**WATANABE:** Dr. Falkenhausen, thank you very much for taking time to meet with me today. I have been involved in much research on German takeover rules and its actual practice both in an official capacity and as an individual; however, there are still many points that I do not understand very well. As is the case for UK takeover rules, the more I learn about the actual practice of German takeover law, the more surprised I become upon recognizing the dynamics of parties’ actions that are unforeseeable from the explicit rules, and the more questions I have. Since you are professional experts in M&A practices and takeover bids in Germany, I would like to ask you questions on these topics.

**FALKENHAUSEN:** It’s my honor and pleasure. I hope I can provide answers to your questions by sharing the experience and knowledge we have gained. I asked Dr. Dirk Kocher, a lawyer from our office who has expertise in M&A like me, to join our interview today.

**WATANABE:** First I’d like to ask you some concrete questions. In Germany, how different are the rules to which are applicable between mandatory offers and voluntary offers? First, I’d like to confirm about it.

**FALKENHAUSEN:** There is the voluntary offer, which will not get you over you 30%. This voluntary offer is not subject to any price regulation. You are free to offer any price you like.

If you make a voluntary offer that can get you over 30%, the price regulation is exactly the same as it is for a mandatory offer. And if you make such an offer (which is called a takeover offer in Germany), then you must always make an offer to all shareholders for 100% of the shares.

**WATANABE:** But I suppose there is a slight difference in price regulation between mandatory offers and voluntary offers. If I recall correctly, you referred to that last time. Maybe the starting point is the average market price.

**FALKENHAUSEN:** Well, there is a slight difference that is very important in practical life but which is theoretically not such a big difference. The offer price is always the higher of your own acquisition cost (the price you have paid to other shareholders in the previous six months) and the average stock-exchange price over the previous three months.

However, in a voluntary offer you can fix yourself the date from which you count backward. In a mandatory offer, the date on which you have acquired control of the company is the relevant date.

Take for example an M&A transaction, which very often in Germany begins by buying a large block of shares. If you buy the large block of shares, you must announce that you have bought the block of shares, which will trigger a mandatory offer, if it is over 30%.

Then the stock-exchange price will go up, but it usually takes a while before the deal is closed. Then you have to do the mandatory offer, and then the stock-exchange price is high, and you have to pay this high price in the mandatory offer.

You can avoid this by announcing a voluntary offer on the first day when the deal is published. So the stock-exchange price is counted three months backward, which is usually lower than after the transaction has been announced.

That is the practical difference. And doing a voluntary offer instead of a mandatory offer is very common in Germany.

The law says that if you do a voluntary offer that fulfills all the rules for all shareholders, then you
do not have to make a mandatory offer later.

**WATANABE:** But I suppose such a difference is very important in practice.

**FALKENHAUSEN:** Yes. It can cost a lot of money if you do it wrong.

**KOCHER:** Absolutely.

**WATANABE:** And if so, most takeovers in practice should be voluntary ones. But according to the statistics of the BaFin, the number of voluntary offers is nearly the same as the number of mandatory offers.

### 2. Reality of the exemption from a mandatory offer

**FALKENHAUSEN:** Yes. I have seen these statistics. And you are asking why. There is a whole range of explanations. First, as I said, you can do a voluntary offer instead of a mandatory offer. But there are many mandatory offers that have nothing to do with M&A transactions. For example, a listed company had one shareholder holding 78% of the shares.

And then, not the direct shareholder changed, but somewhere between indirect shareholders a transaction was made, and ultimate control went to somebody else.

This has triggered a mandatory offer at the listed company in Germany. But there was no M&A transaction in Germany. All these changes had happened outside Europe.

We had another situation, which Dirk will remember very well. Again, there was a listed company in Germany. And the major shareholder held just over 98% of the shares. Then the major shareholder did a spinoff. They separated one part of the business into a separate entity, which in the end had the same shareholders. But the entity was not anymore within the same group of companies. So the new entity had to do a mandatory offer for the free float. This happens.

So there are many mandatory offers that happen outside of M&A transactions. Plus there are a 100 or so exemptions from the mandatory-offer requirement, which the BaFin grants every year.

**KOCHER:** And some of the cases where we see the mandatory offer are really cases where people did not apply for the exemption in time. You only have one week to apply for the exemption. And sometimes it happens, especially if the control changes in a foreign country, and the shareholders there don’t realise that they have a listed participation in Germany.

**FALKENHAUSEN:** They just forget it.

**KOCHER:** They simply forget it. And then if more than one week has passed, they don’t get the exemption anymore. And they have to do a mandatory offer, sometimes very much to their surprise.

**WATANABE:** In such cases, did the buyer make a mandatory offer actually?

**KOCHER:** Yes.

**WATANABE:** Actually?

**FALKENHAUSEN:** But you see, in these cases you make a mandatory offer because you have to do it. Usually, it is not attractive. It’s just a proceeding that costs money and a lot of lawyers’ work and publication. You do not buy many shares.

But there are other cases where it becomes very important that you do things right in order to not trigger the mandatory offer, because it would be extremely expensive.

**KOCHER:** In the case, for example, where the main shareholder already had more than 98%, the mandatory offer made was for less than 2%. So it was not very expensive. The transaction costs were higher than
the price they paid for the shares.

And at the same time, if you do not do a mandatory offer, even though you are obliged to make it, all your shareholder rights are put on hold. So you don’t have the right to dividends, and you don’t have the right to vote in the general meeting before you have done the mandatory offer. And that is, of course, a very strong incentive to make the mandatory offer.

**WATANABE:** It is very surprising. And does the BaFin have jurisdiction over that?

**KOCHER:** The BaFin looks at these cases. And if they think that you have to do a mandatory offer, they will tell you that you have to do one. Otherwise, if you are still in the one-week period, they very often grant the exemption. I don’t think the BaFin sees a problem in the situation as it exists currently.

**FALKENHAUSEN:** Well, there is a little bit of discussion on whether we need reform, not of the mandatory-offer requirement as such, which I do not like too much, but it is in the European regulation, and it will not go away.

But we have some discussion about the exemptions. For example, there is one exemption for transactions within the same group of companies. And it is very simple. You just write to the BaFin, and you say, “I want this exemption.”, explaining why this is a group of company situation. And the BaFin will grant the exemption.

But there is a strong movement saying that we should not have this procedure where you have to go and apply for an exemption and then the exemption is granted. Instead, we should have a general exemption saying all transactions within the same group are exempt by law.

And I’m very much in favor of that. It’s against my own interest, of course, because we earn our money by writing these applications. But these applications have to be very detailed. Then the BaFin reads your application, and then the BaFin makes an order granting your exemption. And this order has to have reasons behind it.

So the BaFin person spends probably one day or more granting the exemption. And then you have to pay a fee for that. All this is very interesting, but not necessary. It should be abolished.

There is also a little bit of discussion regarding the exemption in cases of restructuring. If a company is near insolvency and needs restructuring, you can get that exemption. And there is some discussion about whether it should be easier.

I have a concept which unfortunately is not shared yet by many others. I’m in favor of changing the price regulation for mandatory offers. Right now it says that the offer price must be at least the higher of the highest price the bidder has paid in the previous six months and the average stock-exchange price over the previous three months. I am in favor of abolishing the stock-exchange price from this rule, because I think the price you have paid is a much better indicator of how much the shares are worth. And there are situations where the mandatory-offer requirement just makes it impossible to do a transaction.

Should I give an example? I have a client who holds 48 or49% in a listed company. And this client wants to sell. If this client sells to somebody else, the buyer must make a mandatory offer. The stock-exchange price right now is much higher than the real value of the company.

So we have an investment bank looking for a buyer. And the investment bank comes back and says, “We have a buyer.” And the buyer says, “We will make the mandatory offer to the free-float shareholders. But for your client (the 48% shareholder) there is no money left, because the mandatory offer is so expensive. We can pay 1 euro for 48%, not 1 euro per share but 1 euro for 48%, nothing else.”
And, of course, our client has said, “I’m not going to sell for 1 euro.” So the transaction just could not happen.

And that does not make sense.

3. Conditions to be allowed for a mandatory offer

WATANABE: Next, I’d like to ask you a question on the conditions allowed for a mandatory offer.

KOCHER: If you happen to make a mandatory offer, there are not many conditions that are allowed anymore in Germany. Basically, only conditions imposed by law are allowed, for example, merger control or other regulatory controls that stop you from closing the transaction. If the target is a bank or insurance company, it is possible that the BaFin does not accept the new shareholder. The situation is similar for industries such as weapon production. But that’s all - merger control, and other regulatory approvals.

FALKENHAUSEN: In England, I understand the mandatory offer is always under the condition that it is accepted by 50%, which seems to have some connection with the creeping-in rule which states that you have to do mandatory offers between 30% and 50%, which we do not have in Germany. In Germany, you do your mandatory offer once, and then you’re free to acquire new shares.

I am not sure that I have understood your question about preventing coercive offers. Coercive offers are offers, I understand, where the shareholders are put under pressure. In Germany, the way we try to avoid coercive offers is the rule contained in Section 16, Subparagraph 2 of our code, which says that every shareholder who has not tendered his or her shares has an additional window of opportunity of two weeks after the offer has been closed. This allows the shareholders to see if the offer is successful. If the offer is successful, for example if it has a 50% or 60% acceptance quota if it’s a voluntary offer, it may be better for the shareholder to tender his shares. If the offer is not successful, then the shareholder can decide not to tender. So this takes away the pressure to tender the shares if you do not really want to because you think the price is too low.

The rule works rather well in our experience. In our experience, it is not a little old woman on the street who sits there with her shares. It’s all about hedge funds. Most of the free float in such a situation is controlled by hedge funds. And the hedge funds usually have kind of a common opinion whether they want the offer to succeed or not. They cannot coordinate too much, because otherwise they would violate many rules. But they have an idea whether they say “The price is good” or “We don’t want the price.” Sometimes, we have seen that in the Bayer and in the Techem transaction, and - I think - in the Repower case, they say, “Yes, we want the offer to succeed, but we want to retain as many shares as possible, because later on there will be a squeeze out, and the squeeze out will have a higher price.” So they would say, “Well, we will tender only as many shares as necessary,” and in Bayer and Schering the minimum acceptance quota was 75%, and for some reason I think Bayer got a bit more, they got like 80% of the Schering shares. And then in the additional two-week period, the small investors tendered nearly all their shares, so they got another 6% or 8%. But the hedge funds usually play a game. And you see, it’s not about being coercive, because you cannot coerce hedge funds if you have them against you. They can rather put pressure on you. There is sometimes substantial pressure to increase the offer price.

And this only applies to voluntary offers. Mandatory offers usually happen only after a deal has been done.
KOCHER: In a mandatory bid, there is not much that the bidder can do. It has acquired the stake, and it will simply have to do the mandatory offer, and then see how many shares will be tendered. And I don’t think in case of a mandatory offer the shareholders are coerced. They can stay on board, and then they’re protected by the rules governing groups of companies, so the majority shareholder cannot take out money from the company, where others don’t participate. If the bidder takes structural measures like a squeeze out afterwards, there are protection rules as well. There’s the appraisal procedure, where the minorities can go to court and have the valuation of the company examined. So nothing speaks against staying in the company if you think the price paid in a mandatory offer is too low.

FALKENHAUSEN: Correct. But the assumption is right. We do not have conditions other than merger control and regulatory approval in mandatory offers.

KOCHER: Absolutely, yes.

4. BaFin and UK Takeover Panel

WATANABE: By the way, as you know, the price regulation of a voluntary offer in the UK is not so severe. So why in Germany did they introduce such a severe price regulation?

FALKENHAUSEN: Germany by tradition has an administration based on rules. And we have the BaFin, our regulatory authority. It is part of the administration, and therefore it abides strictly by the rules.

In the United Kingdom the Takeover Panel is an institution on a voluntary basis, I understand basically organised by the financial institutions, by the banks, etc. And the Takeover Panel has rules. It has the City Code. But it can apply these rules in a very flexible way.

And the German BaFin is a government authority. They have to follow the rules. They cannot say they would like to deviate from the rules. That is not possible.

We have had a situation, which is quite interesting. Bayer took over Schering, a pharmaceutical company. And Schering, the target company, was listed in Germany and in New York. So Bayer had to do the takeover offer under German rules and under the rules of the SEC. In some cases they were in direct conflict.

So one of them had to do something, deviate from the rules. And it was always the SEC, because they have the freedom to apply or not apply the rules. SEC has discussed with BaFin, and BaFin had to say that they had no flexibility to grant an exemption from the German rules.

So the SEC had to grant exemptions. The SEC is more flexible than BaFin.

WATANABE: Yes, I understood. But our impression about the BaFin after we ourselves visited is that in the course of ordinary regulation by the BaFin and the Takeover Panel are very similar.

FALKENHAUSEN: It is correct that the structure of the rules of the BaFin and the Takeover Panel are similar, as far as I know. You probably know much more about this.

The BaFin and the Takeover Panel speak to each other and discuss. And very often, if you look into the German legal writing, the Takeover Panel in the United Kingdom is the example, the precedent. Very often people would say, “If it’s good in England, it must be good in Germany.” We tend to assume that the Takeover Panel is doing the right thing as it has 20 or 30 years of experience. I disagree sometimes. But we must acknowledge that the Takeover Panel has more experience than anyone in Germany.

WATANABE: I suppose that an important difference between the Takeover Panel and BaFin is whether
they can voluntarily set and operate concrete rules, as private practitioners constitute the majority, and whether they can refer to the principle-based rules ultimately. They have different approaches on that point.

**FALKENHAUSEN:** I think what you are saying here is a very good summary of the way it works in Germany and in the UK. In Germany the BaFin can establish rules only within the law. If the law has a regulation, then we have the law, and we cannot go away from it.

In England, the Takeover Panel can change the code. It has discretion not to apply the code or to make new rules. And the FSA (Financial Service Act) only has an umbrella role: Whatever is in the code can be enforced by the FSA.

Second, private M&A practitioners are the majority of the Takeover Panel. The BaFin consists of government lawyers. And there is an advisory board at the BaFin. Professor Hopt is on this board.

But to be honest, I'm not sure how active this board is. It is not involved in day-to-day decisions.

**WATANABE:** I heard that the BaFin itself also said so.

**KOCHER:** And we know that some of the government officials working at BaFin have worked as lawyers in law firms before and then moved to BaFin. So they have some background and some experience, some of them, from their previous careers. And they know the game from our perspective.

**FALKENHAUSEN:** Correct. And in the Takeover Panel you have personalities with very long experience, who know what they are doing.

But BaFin is quite good. They can think very practically.

But one thing they cannot do, because in Germany you just cannot do it, is give exemptions from their rules if the rules do not allow an exemption.

You can get an exemption, for example, from the mandatory offer in the cases described in the law.

In England the Takeover Panel could say that a mandatory offer is not appropriate, than an exemption would be granted.

In Germany this is not possible.

**KOCHER:** And that also explains your item No. 3 already a bit. The BaFin can only use general principles as a way to interpret the rules. Only if they are not absolutely clear, BaFin can use transparency and, for example, equal treatment as important principles of interpretation.

But as long as the rule is clear, the rule is the rule. And then the BaFin cannot change it, even if they think that under the general principles it may be desirable.

**FALKENHAUSEN:** Yes.

5. The case of Porsche/Volkswagen and cash confirmation

**WATANABE:** Next, I would like to ask you some specific questions regarding Porsche v. Volkswagen, OK?

**FALKENHAUSEN:** That is difficult, yes.

**WATANABE:** There should be a cash confirmation. So did Porsche actually pay a cash confirmation fee in that transaction?

**FALKENHAUSEN:** I was not involved in this. So I can talk about it. If I had been involved, I would be
under professional secrecy.

I do not know for sure. If you look at the documents that have been filed with the BaFin by Porsche for the mandatory offer, it is said that the transaction costs were, I think, 126 million euros, a lot of money.

And the cash confirmation, which Porsche had to obtain from a bank, must have covered 26 billion euros.

And I would assume, but I cannot say for sure, that a big part of the transaction costs was paid for this cash confirmation. This is remarkable, because I think only 0.001% of the Volkswagen shareholders had tendered their shares in the mandatory offer, because the mandatory offer was not attractive at all.

It was not attractive, because the stock-exchange price at the time of the offer was higher than the average stock-exchange price which was offered in the mandatory offer.

This may sound absurd: The cash confirmation seems to be an easy thing, as Porsche knew that they would not have to pay much.

We have had a similar situation. There is a shareholder in a listed company holding 29.7%. And this shareholder wants to increase and therefore has to do a mandatory offer.

And then, they thought it was a good idea to do it like Porsche, because the average stock-exchange price was below the present stock-exchange price. So the offer would not have been attractive.

But in this case it was not 26 billion. We needed a cash confirmation for 500 million in this case. And the banks were hesitant. So it did not happen.

But do you know what happened? Exactly in the time when this mandatory offer would have been made the share price fell from 50 to 30. So if the mandatory offer, which I think would have been at 48, had been open, all shareholders would have tendered their shares. And then all of a sudden, the cash confirmation is real. And the bank which had give the confirmation would have had a risk to pay up to 500 million or so.

So one cannot say that the cash confirmation is theoretical. It can always happen that in a mandatory offer if the stock-exchange price goes down you have to buy a lot of shares. **Kocher:** Yes. And there is another problem with the cash confirmation. Sometimes you have an agreement with an existing shareholder that he will give his shares to you outside the offer, but the deal is not yet closed. Or you have an undertaking from another shareholder that he will keep his shares and not tender them in the offer.

And then the bidder sometimes go to BaFin and asks that these shares should be excluded from the calculation of the cash confirmation, because they will never be tendered. BaFin does not allow that, because they say, “You may have an agreement with this shareholder, but this shareholder may breach it and sell his shares to somebody else on the market, to an innocent shareholder who doesn’t know about this deal. And if he wants to tender, he has to be protected.”

So even if you have an agreement with a lot of people that they will not tender their shares in the offer, you still need the cash confirmation for all the shares that you do not own yourself. That makes it expensive.
6. Rules for competing offers

WATANABE: I’d like to move on to the next question. Concerning competing bids, you said last time I met you that you had a case in Switzerland.

FALKENHAUSEN: Not me, but I have read that case, yes.

WATANABE: I’ll appreciate if you explain me more about that case.

FALKENHAUSEN: The case was about the question whether you have to have equal treatment of all bidders by the target company.

In Germany we do not know yet whether there is an obligation of equal treatment of all bidders by the target. In my opinion, there is not. Others have said that there should be.

There is no rule in our statute. So the BaFin could interpret the law both ways. BaFin has not formed an opinion yet.

In Switzerland there is a rule in the law that if the target company gives information to one bidder it must give the information to all other bidders, unless there is a prevailing interest of the target company.

There was this case that went all the way up to the Federal Court, the highest court in Switzerland. The company was called SIG. There were two competing bids, and the target preferred one bid over the other. I think it was a white-knight situation. The target wanted to give one of the bidders access to documents in a due diligence.

So the Swiss Takeover Commission decided that these documents had to be given to the other bidder, too. If the target wanted to obtain an exemption, it would need to state the reason for each individual document, and the Commission would then decide document by document what should be given to whom.

In my opinion, this is micromanagement and there is the danger that the transaction is not managed by the parties but by the Takeover Commission.

Switzerland, of course, is very efficient, but it is difficult to imagine to go to the BaFin, discuss 1,000 documents, and to argue that 200 could be shown to bidder No. 1, another 300 to bidder No. 2, but no documents to bidder No. 3, because bidder No. 3 is a direct competitor. That is not doable, in my opinion.

But the Swiss law is different in this respect.

KOCHER: We don’t interpret the rules of our takeover code to say that you have to give the same information to all the bidders. Our code contains a rule that you are not allowed to obstruct a bid. But it doesn’t really contain a principle of equal treatment of bidders. So that would be a new development. And some lawyers are in favor of such a development, and try to achieve it by interpreting the code.

FALKENHAUSEN: Yes. And the practical consequence would be that the target company has a very easy way of saying, “I cannot give you any documents.”

We have seen this in a case, where our clients were the white knight. And even in that case, the target company management had called our client and asked for help because they did not like the first bidder.

But still, their lawyers said that even though they did not assume that a rule of equal treatment of bidders exists, they needed to be very restrictive about showing you any information. They could not
exclude that they were wrong, and then the BaFin might order their client to show the documents to the other bidder. As all bidder were competitors in the same business they didn’t want to show anything sensitive to the other bidder.

So our clients in the end made the bid, and everything went okay. But they could not do as much due diligence as they wanted to, which is not good for doing transactions.

WATANABE: Yes. I agree. If so, why does such a regulation function in Switzerland or maybe the UK?

FALKENHAUSEN: It exists in the United Kingdom. It is a bit different. I think it is Rule 20 of the Takeover Code. And it says, “If you give information to one bidder, you must give it to all bidders upon request.”

In Switzerland the rule seems to be that you must give it to all bidders without a request.

But Switzerland seems to be able to live with it. It works in the UK, too. The Panel is always flexible and usually finds a pragmatic way.

WATANABE: I suppose from the practical point the German system may be more reasonable.

7. Equity derivatives and “hidden ownership”

WATANABE: I would like to move on to the next question about equity derivatives.

FALKENHAUSEN: This is a difficult subject.

WATANABE: Why is it difficult to regulate equity derivatives in the context of takeovers in Germany?

I suppose it may be related to the price regulation of voluntary offers in Germany, in particular the average price regulation.

You said that the market price have been going to be high after a bid was announced.

FALKENHAUSEN: First, we have to differentiate equity derivatives. The discussion of equity derivatives, as you know, started in 2008, when Schaeffler made a takeover bid for Continental.

The discussion did not center on mandatory offers. It was a question of disclosure of shareholdings. So far, disclosure in German is based on the concept of disclosure of voting rights. You have to disclose how many voting rights you hold. And, of course, if you have an equity derivative, e.g. in the Continental case a total-return equity swap, then you do not have any voting rights. You just have a monetary position.

Prescribing disclosure of derivatives which do not allow access to voting would require a change of the system. And there has been a call for a change of the system. In my opinion, there are two reasons why we need to be very careful, and better slow than fast in the regulation of equity derivatives. One is that we need to know more about the role of equity derivatives outside of the takeover context.

We probably have millions and billions of equity derivatives being traded every day. And if you would introduce disclosure duties for these equity derivatives, you could come into a situation where the companies would receive many of notifications of voting rights or of equity derivatives. And it may become too much.

One of our problems of disclosure of shareholdings is that the German notifications are so complicated that they are very difficult to understand.

If you look at the notifications that have been published - and they are in a database of the BaFin – you will find that often only a lawyer who knows this situation could explain to you what they mean.
Often the notifications add up to much more than 100%, because you have direct and indirect shareholdings.

That’s one point. The other point is if we close this “hole” of equity derivatives, the advisors have already found at least one, if not several, other approaches for how to creep in without disclosing.

There are two strategies that have been discussed in public. One is the loan of shares, like a repurchase agreement. You buy a 2.9% shareholding. That small amount does not trigger notification duties. And then you give these shares on loan to somebody else. So you don’t have any. Then you buy another 2.9%, and you give those shares on loan to a third party. Then you buy another 2.9%, and you give that block to a fourth party on loan. So in the end you have several times 2.9% on loan to a number of parties, with no notification required under German law.

All these share loans are unwound at the same time. So you may own far over 30% of the shares without ever having disclosed anything before.

The present position of BaFin on share loans is that they do not trigger notification duties.

KOCHER: But that is not very clear in the law. We could interpret it in a different way.

FALKENHAUSEN: It is.

And the other strategy was mentioned by one of our colleagues. Options have to be disclosed. But an option does not have to be disclosed if it is under a condition which you cannot fulfill yourself. So he proposed to buy 50% of the shares in a target under the condition of merger control. Merger control is outside your control. This conditional purchase agreement triggers no notification duty.

So my attitude on equity derivatives and changing the law is that it is similar, as we say in Germany, to the rabbit that chases the groundhog. It will always be one step too late. When you change the law, the bankers will have found the next strategy.

KOCHER: At the same time, as you already mentioned, if you create too many notification duties, you also confuse market, because a lot of people use these derivative instruments not because they want to have influence or control. It’s simple speculation for money.

FALKENHAUSEN: Or hedging.

KOCHER: Or hedging. And if they suddenly have to disclose, then there is a lot of confusion, because the investors may think this is the hostile-takeover attack. But it may in fact only be hedging or simple financial speculation in order to make short-term profit.

FALKENHAUSEN: We have a regulation of these equity derivatives in Switzerland, as you know. And I think they we are introducing it in the UK.

Probably in the UK they will find a way to distinguish between those where disclosure is necessary and those where disclosing would be just confusing.

I’m not sure how it works. I heard that under the UK rules you don’t have to disclose if you are a client-serving intermediary.

We may find such rules in Germany. But I’m very much concerned that these rules have to be applied in a very flexible way. Otherwise it would be extremely difficult.

And one of the reasons why nothing has happened in Germany so far, is that after Continental and Schaeffler we had a financial crisis. We have other topics on the agenda, which have nothing to do with it.

These days everybody is crying out about directors’ salaries and bonuses for bankers, and all that.
So they seem to have forgotten about the equity derivatives.

8. Issues on the disclosure of the real beneficiary of a takeover bid

**WATANABE:** Next, I would like to ask you a question about the practice of disclosure of substantial beneficiaries.

**FALKENHAUSEN:** We are talking about disclosure in the offer document. That is a different kind of disclosure.

**KOCHER:** We have to disclose the whole shareholder structure, as far up the ladder as there is control. That is, of course, very important. Then you also have to tell how you financed the offer, whether in equity or in debt.

**FALKENHAUSEN:** What do we have to disclose regarding the indirect shareholdings, who represent the investors? We have to disclose the bidding vehicle (the bidder) plus shareholders in control, plus everybody acting together with the bidder. This could be parties with shareholding, voting agreements, etc.

But generally the question of whether you have to disclose private equity funds is a very delicate problem of analyzing the structure and in the end a question of control.

**KOCHER:** It is indeed a question of control. That’s the important point. In a typical private equity structure, where you have a structure of acquisition companies that each hold 100% of their respective subsidiaries, of course, all of them have to be disclosed.

On top, you usually have a limited partnership. This limited partnership is usually in an offshore jurisdiction.

It usually has a general partner who controls the business. Then, the shareholding is attributed to the general partner and to the persons who own the general partner if they are acting together. But very often the general partner is owned by individual partners of the private equity sponsor and not a single one of them controls it.

And then you have as limited partners the investors who give the money.

**FALKENHAUSEN:** Usually you don’t disclose them, unless any one of them holds over 50%.

**KOCHER:** Exactly. But that is usually not the case. I don’t think we have seen any example in Germany where the individual investors in this limited partnership would have been disclosed, because none of them has control. If they act together, they would have control, if they can remove the general partner.

But usually you have at least five or six or seven investors there. So none of them has control. Therefore, you don’t have to disclose who has invested in the limited partnership as the private equity fund.

**WATANABE:** I suppose such a practice is reasonable. What are the grounds for such practice? Is there any explicit rule, or is it an application of an explicit rule?

**KOCHER:** It’s an application of the rules that we have, because we have rules for the attribution of shareholdings “upstream”, which prescribe attribution to the parent company. Parent company is defined by a controlling influence.

In the structures we just described usually the individual investor doesn’t have control over these limited partnerships. He doesn’t really have influence. So I think it’s a strict and correct application of the rules that we have. The rule does not say to disclose investors or not. It simply says to disclose everybody
upstream who has control.

And under the structures that private equity funds use for Germany, the investors in the fund do not have control.

**FALKENHAUSEN:** Section 2, Paragraph 5 of our Takeover Code defines persons acting together. Subsidiaries and parent companies are acting together. Subsidiaries are defined by reference to our commercial code.

The commercial code uses a control concept. Majority ownership grants control.

So there is not much discretion. It’s all clearly defined in the law. But the interpretation, if you look at a limited partnership under Cayman Island law or under Bahamas law or Jersey law, is sometimes very difficult.

Looking at a typical acquisition structure, you have a bidder usually held by interim holding companies in Luxembourg, for tax reasons. Above them, there is a limited partnership in an offshore jurisdiction. So it is clear that you have to disclose the bidder, the interim holding companies, and the limited partnership itself.

Usually you have to disclose the general partner. That is a question of interpretation. But the limited partners, who possibly hold 10% or 5% you do not have to disclose.

And, of course, if the general partner has a parent company, then you disclose that one.

For example, and this is public knowledge, one of our clients is One Equity Partners (OEP). OEP is a private equity sponsor. The general partner of all OEP funds is majority-owned by J.P. Morgan Chase Bank. So we have to disclose all the interim holding companies plus the limited partnerships plus the general partner plus J.P. Morgan Chase. And this makes a disclosure that nearly nobody can understand. That’s one of the problems of disclosure under German law.

**WATANABE:** Do you think it should be more reasonable?

**KOCHER:** I think these disclosure rules are very reasonable, because they are based on the control principle. Just technically they are made in such a way that it’s very hard to understand the disclosures. I think the law should basically say that you have to paint a graph so that the investors can understand the structure.

**FALKENHAUSEN:** If you could file such a diagram, everybody would understand it. But we cannot do that. and if you describe the structure in words it becomes very confusing.

This rules are in Section 2, subparagraphs 5 and 6 of our Takeover Code.

**KOCHER:** It makes reference to the commercial code for the rules when you have to consolidate companies in the financial statements. And the concept there is one of majority ownership or control by other means.

### 9. Worker’s influence and the offer price

**WATANABE:** I’d like to move on to the next question. Why is the validity of the offer price the main topic in the statements made by the supervisory board of the target company in Germany where the workers’ influence is very strong?

**FALKENHAUSEN:** First, under German law, under Section 27 of the Takeover Code, the management board and the supervisory board must make a report and comment on the takeover bid. And in this take-
over bid, they must also comment on the takeover price, whether it is good or bad and whether they recommend accepting the offer or not.

This is a concept that is logical in itself. But then in the process of legislation protection of the workers came up. So it was introduced into Section 27 that everything must also go to the workers’ councils.

This may have been put into the law in order to obtain the right political support for the law. But the information of workers and the rights of the workers to comment do not fit into this system well.

When the supervisory board comments on the offer price, this is done for the shareholders, to tell the shareholders whether the supervisory board thinks it’s a price that is recommended or is a price that is not recommended to be accepted.

The supervisory board and the management board must also comment on the question of what the consequences for the workforce will be. This is not of direct concern for the shareholders as they usually care about their investment.

Very often standard wording is used in this statement, which is usually a joint statement of the management board and the supervisory board (in nearly all cases they do just one statement together), about consequences for the workforce, saying that nothing will happen to the workers.

KOCHER: It’s also important that in the offer documents the bidder has to disclose its plans regarding the workforce. They usually also say from a legal perspective nothing will happen. And then they usually say that action may be considered in the future, but that they don’t know yet. So it’s usually quite vague.

Then, the management board and the supervisory board of the target company simply copy that and say, “The bidder has sent [this, this, and this], and we don’t know much more, either.” So it is very vague. It is often not very helpful.

The shareholders, unless they are very worker-oriented, which is very seldom, or if they are workers maybe themselves who hold some shares, are simply interested in whether the price is a good price.

However, if you have a hostile bid, and there is maybe some kind of takeover war, this may be a good place for public-relation action. You can try to argue against the bidder. You could say, “And it may also be dangerous for the workers.” So it may be a way to gather political support. But that is something that you also could do with the media without this statement.

FALKENHAUSEN: We have not had very many hostile takeover bids, probably four or five. In the Continental and Schaeffler case, the situation arose that Continental had the northern German metal workers’ union supporting the defense against Schaeffler.

And Schaeffler had the Bavarian metal workers’ union (and they are all part of one big union) supporting the bid of Schaeffler. It was similar with the politicians. The northern German politicians were against the bid, and the southern German politicians in Bavaria were in favor.

When you have a hostile situation, you try public relations with the workforce and with the press and with the politicians. Usually you look at who you know and where you are, but these are not legal considerations.

WATANABE: I have heard that when the supervisory board is against a hostile takeover they usually say that offer price is very low, not good.

FALKENHAUSEN: Yes, if they can say it, I have advised in a small bid, long time ago. The target com-
pany was against the hostile bid. The strange thing was that they said, “If we are taken over by the bidder, this will be disastrous,” because they were in the same industry and they were afraid that all their customers would run away. “But to be honest, the price is so high that we must recommend to everybody to accept the bid at once, because they are offering much more than our company is worth.”

That is rare. And normally, e.g. in Continental and Schaeffler and in Mannesmann and Vodafone and the other few hostile offers, the target always stated that it was worth much more. We have also seen it when Merck made the first offer for Schering, before Bayer came in as a white knight. The first thing is Schering management said, “Our shares are worth much more.”

KOCHER: And then they start negotiations, and most hostile bids in Germany after a while turn friendly, because the price is increasing. Then, the boards recommend that the better price is accepted.

FALKENHAUSEN: Even for Continental Schaeffler increased the offer to 75. And then the industry went down, and Schaeffler was nearly ruined.

But that is not a legal problem. This was the financial crisis.

WATANABE: I heard that in the course of time, Schaeffler was about to be merged into Continental. Is it true?

FALKENHAUSEN: They are not yet merged. What happened was the following: Schaeffler made a bid for Continental, and they already had 30% control by equity derivatives.

Then Continental searched for white knights. If I remember correctly, most of the white-knight candidates (private equity sponsors) said, “Well, the price is so high. We cannot pay more than Schaeffler.”

So in the end Continental agreed with Schaeffler that Schaeffler would increase the offer to 75 euros per share but that they would buy only 49%, and the other shares would be given to a bank.

90% of the shares were tendered, 49% were taken by Schaeffler, and 40% were taken by the banks, but the financial risk was with Schaeffler. And that was at a price of 75. And then the share price, while the offer was open, fell to, I think, 25.

Schaeffler was never bankrupt. None of the banks wanted to do anything that could make them insolvent. But they have restructured Schaeffler and Continental. Continental was in a very difficult situation itself. And they want to merge the two sooner or later.

But all this is pending. And right now Continental has done a capital increase, a rights offering, under which the Schaeffler shareholding has been diluted, because they needed fresh money.

And I don’t know where it will go. But the Schaeffler family was very rich before they made the offer. And they were not so rich anymore after the offer has closed.

KOCHER: And this is also a very special situation, because Continental had change-of-control clauses in a lot of its financing. That is the reason why it was at the end of the day agreed that Schaeffler would only take 49% and the rest would be parked with banks in order not to trigger the change of control under the Continental financing.

WATANABE: But generally, is such a change-of-control clause valid in the context of takeovers?

FALKENHAUSEN: A good change-of-control clause is a very effective defense against a takeover. And we do not know whether the change-of-control clauses in the financing arrangements of Continental were there because the banks wanted them or because Continental wanted them as a takeover defense.

We had a law passed about four years ago, which introduced a requirement that the listed compa-
nies must write a report every year about obstacles to takeovers, like change-of-control provisions.

So before Schaeffler made the bid for Continental, they looked very carefully at this report, which is in the annual accounts. And there it was stated that they had a change-of-control provision in their financing of 12 billion euros or so. The clause stipulated that if someone acquired more than 50% of the shares, the financing could be terminated.

Such a change-of-control clause is a very dangerous weapon.

**KOCHER:** For the target company, of course, this can be very efficient protection. But it doesn't distinguish between a good bid and a bad bid, a good price and a low price. It's always there. So even if there is a bidder who you think is a very good match, with a very good price, you still have the change-of-control clause.

**FALKENHAUSEN:** Yes. It is out of control.

**KOCHER:** Yes. It is out of control. It is not a weapon that you can decide to use or not. And then you have to discuss it with the banks. And if the banks are asked to waive it, they will always ask for a big fee if they agree to do it.

**WATANABE:** Generally, does the BaFin allow the use of such a change-of-control clause?

**FALKENHAUSEN:** They are not asked.

**KOCHER:** They don't have any jurisdiction over that.

**FALKENHAUSEN:** That is possibly different from the Takeover Panel. On the one hand, BaFin is not flexible to go away from their rules. But in the other hand, they have no jurisdiction beyond what is in the law. And the law just says you must write the report on change-of-control clauses and other obstacles to takeovers. And even that report is not subject to BaFin review. It's just subject to review by the statutory auditor of the company.

And, although it has never been tried, BaFin probably has jurisdiction over takeover defense according to Section 33 of the Takeover Code, which deals with takeover defense after the bid has been announced.

Takeover defense before the bid has been announced is not regulated. And BaFin does not have jurisdiction.

**FALKENHAUSEN:** It is just a question of company law regarding the duty of the management board and the supervisory board to act in the best interests of the company under company law and the capital-markets law. So they have to determine whether it is good for the company to accept such a change-of-control clause or not, to have such a defensive weapon or not.

But you also have to take into consideration that for a lot of financings it is market standard to have such a change-of-control clause. And the banks would ask for it.

**11. “Unternehmensinteresse” (fiduciary duties of the management)**

**WATANABE:** I would like to ask you one more question, about the concept of Unternehmensinteresse. I suppose the concept of Unternehmensinteresse is very important. But there is no specific criteria as to what to do or what would or wouldn't actually be in the interest of the enterprise at the scene of a takeover.

**FALKENHAUSEN:** This is a very interesting question. Unternehmensinteresse in Germany is seen by
the corporate law as mixture or a balance of the interest of the shareholders and all other stakeholders, the stakeholders being the workforce, the public, the customers, the creditors, and others around the company.

There is no order of precedence that clearly says that one goes first. And it is up to the management in its business judgment to pursue these goals in a proper way.

Management could in its business judgment say that shareholder value is first. And management could also say that the interests of the workforce are first. But then, of course, they would have to be asked whether this is a concept that can just by itself work long-term, or whether there need also to be profits, because without profits there is no long-term employment.

German management usually would first see to it that there is long-term profitability of the company. Maybe some will look at short-term profitability which is better for their bonus.

And within long-term profitability, they would look at community relations and employment relations. But there is no strict, legally defined concept.

KOCHER: There is no definition in the law. The German Corporate Governance Commission issues recommendations, which listed companies have to follow or disclose that they are not following them. And the Commission has now put a definition into that latest version of the corporate governance codex, which is also rather vague but it stresses the stakeholder rather than shareholder approach to some extent.

It also contains a definition. It says that you have to look at sustainable profitability in the interest of the company, also looking at shareholder interests, employee interests, and interests of other stakeholders.

It’s No.4.1.1 of the corporate governance codex.

But it doesn’t define what the law is. The definition is only applicable to the codex itself. It is, of course, an important source of interpretation of the law. People will look at it and cite it.

FALKENHAUSEN: This part of the codex is supposed to be an interpretation of the law. And it was introduced for political reasons.

The political reason is to get the unions on board for other changes in the codex.

KOCHER: But indeed, I think the concept of Unternehmensinteresse is a very flexible concept, because you have so many different aspects, and you can decide what is more important.

But for me, the most distinctive feature here is that you are looking at the company and its interests as a separate legal entity and not only at the shareholders. And that, to me, always becomes very clear if you have a change-of-control clause, for example.

If you have a good price offer for your shares that would, however, trigger a change of control clause that ruins your company, then you should defend against the offer if you only act in the interest of the company. There you actually may have an interest to put shareholder interests last.

But this should be a theoretical question, because no bidder will make an offer that would ruin the company that he is about to acquire.

FALKENHAUSEN: Yes, we hope so.

KOCHER: A bidder may want to push a target out of the market, but normally only reasonable offers are made. So the interests are actually not so different.

But this change-of-control situation makes it very clear to me that the management also has to
look at the interests of the company as a separate legal entity, separate from its shareholders.

**FALKENHAUSEN:** Yes, but the Unternehmensinteresse in a takeover situation has limited importance. First, the management of the target has to look after the Unternehmensinteresse in their comments under Section 27. That’s very formal.

Second, it may take defense action in the Unternehmensinteresse. But in reality, takeover defense under Section 33 of the Takeover Code has never happened in Germany. It is not effective, and I think it virtually does not exist. If you do takeover defense, you must do it long before the offer is ever announced. Then you have the general duties, which is to pursue the Unternehmensinteresse.

There is one further application of the Unternehmensinteresse. And that is not written in the law. Very often (and we have seen it in some cases) the bidder and the target make a business-combination agreement. And this is where the management of the target can agree more than just financials. For example, when Bayer and Schering agreed on the takeover they made a business-combination agreement by exchange of letters. It was published. The exchange of letters contained an undertaking of Bayer to offer a certain price (86 euros per share), but also the obligation of Bayer to maintain the name Schering as Bayer-Schering Pharma and an obligation to continue to operate the Schering Foundation, which I think is a charitable research foundation. Furthermore, there was an obligation to treat Schering employees and Bayer employees equally when there were layoffs. They had to reduce the workforce by 6,000.

This is typical for a business-combination agreement, the kind of action management of a target can take that goes beyond just the financial interests of the shareholders.

It did not take long to negotiate it, because it was not very controversial.

I think a business combination agreement is a meaningful thing for target management to do. This is where the Unternehmensinteresse is relevant.

**WATANABE:** Very interesting. But I suppose flexible may mean at the same time ambiguous.

**FALKENHAUSEN:** Ambiguous? It is very ambiguous, indeed.

**KOCHER:** You sometimes have situations where you have two alternatives, and a skillful lawyer will be able to argue for both that they are in the best interest of the company!

**FALKENHAUSEN:** Of course.

**FALKENHAUSEN:** And it’s business judgment.

**KOCHER:** Business judgment, indeed.

**WATANABE:** I suppose such ambiguous aspect of this notion may be sometimes advantageous for the persons concerned.

**FALKENHAUSEN:** Yes, but on the other hand, if someone makes a high offer, like Schaeffler for Continental, and the management and the workforce say “This is not in the interest of the company,” it is still a valid offer, and if the shareholders tender their shares, there is nothing that the target can do. So the Unternehmensinteresse does not always help.

**KOCHER:** Indeed. Because at the end of the day, the shareholders decide whether the offer will be successful, and the shareholders care about their own interests, not so much the interests of the company.

**WATANABE:** It is the very distinction between shareholder decision-making and worker protection, I think.

**FALKENHAUSEN:** Well, worker protection is part of Unternehmensinteresse. There is no other worker protection in our takeover laws. There are some information duties to the shareholders under our work-
ers' representation act.

**KOCHER:** But at the end of day, worker protection does not function by influencing whether you can do a takeover or not. Workers are protected because they have their status with the company, they’re employed, and if there’s a new shareholder, of course they keep their rights, and in particular for layoffs you need a social plan. It’s quite expensive, you have long notice periods. So they have this protection already and they don’t lose it. It is probably the common view that there is no need to protect workers specifically against takeovers, because if the new shareholder wants to do something, there is still a lot of protection in place.

**FALKENHAUSEN:** Let us discuss one point which Prof. Watanabe has made here, which is that there are few hostile takeover bids because the workers are so well protected and you do not want to go against the workforce. This may be true, but I’m not so sure. We have clients, private equity sponsors, who said for many years that they would never do a hostile offer. This is changing somewhat. The reason seemed to be that they did not want to force a takeover against the target company management, because they need it. I’m not aware of any takeover project which was not done because the workers were against it. I know of various projects where the management said, “No, we don’t like it,” and then the potential bidder said, “If the management does not go along, we will not do it.”

**KOCHER:** That is indeed very important in the case of a private equity fund, because usually they do not have their own management. They want to continue with the old management, and if they don’t have support from them it’s a no-go.

**FALKENHAUSEN:** But for example in the WMF case, the unions and the workers’ representations were not much of a problem, were they?

**KOCHER:** No.

**FALKENHAUSEN:** It is something you need to look after when you plan a takeover. You will want to plan communication with the workforce. This is very important. But usually, it is not what we would call a “deal-stopper.” It would not stop the deal from going forward. Others may have had other experiences. I am not aware of any transaction in Germany which did not happen because of the workforce.

**KOCHER:** This is just based on the experience of the projects that we have had.

**WATANABE:** Your opinions as well-experienced M&A lawyers are very suggestive.

### 12. Co-determination and the role of supervisory board

**FALKENHAUSEN:** Well, there is one point we probably should also cover. This is co-determination and the supervisory board. In the big companies we have co-determination, and half of the supervisory board members are employee representatives. And this causes interesting situations. Unternehmensinteresse In Bayer and Schering, for example, it was easy, because the Schering management had understood that there would be a takeover, it was just a question of who would take over. And Bayer was the white knight. Everybody wanted them, including the workers, and therefore, there was no problem.

In the takeover of Continental, the employees’ representatives on the supervisory board had a very interesting role, because they could not stop the takeover from happening, but they could take action to make it slower or, in particular, to make it difficult after the takeover to take actual control over the management.
If you as a shareholder want to replace the management of a company, you must first take control over the supervisory board by replacing the present members of the supervisory board, who are elected by the shareholders, and then the supervisory board can replace the management board. And to do all this against the employee representatives is possible, but it takes a lot of time. And therefore, it is quite important at that stage, once you have effected the takeover and want to get control and you want to manage the company, that you find support from the unions and the employee representatives on the supervisory board.

KOCHER: But the Schaeffler and Continental case has also shown that if you don’t have that, there will be a lot of bad press. This case was covered intensively in the press. But it also shows that if you are persistent, at the end of the day, you will get your way.

FALKENHAUSEN: Yes, correct.

KOCHER: But the Schaeffler and Continental case has also shown that if you don’t have that, there will be a lot of bad press. This case was covered intensively in the press. But it also shows that if you are persistent, at the end of the day, you will get your way.

FALKENHAUSEN: Yes, correct.

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