Regulation of Private Equity - Backed Leveraged Buyout Activity in Europe

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Abstract

Private equity-backed leveraged buyout activity in European markets has risen to unprecedented levels in recent years. This has yielded significant economic benefits but it has also prompted deepening concerns about excessive leverage, conflicts of interest, market abuse and general lack of transparency. For policymakers the challenge is to maintain a balance between these competing considerations so that economically worthwhile activity can take place but abusive conduct that is socially wasteful is effectively curtailed. Recent initiatives, such as the European Commission's 2005 Green Paper and 2006 White Paper on investment funds and the UK Financial Services Authority's 2006 paper on private equity, indicate that responses to this challenge are being actively developed.

This article reviews key recent regulatory changes in Europe which, though not necessarily conceived with the private equity-backed leveraged LBO segment of the market specifically in mind, may have significant repercussions for it. The article also considers the market's experience with Article 23 of the Second Company Law Directive on financial assistance, a provision that has been only lightly affected by recent reforms. Superficially, Article 23 appears to address one of the classic agency problems in LBOs, namely, that of target company assets being stripped to service the debt incurred for the acquisition and to provide a quick return to the bidders. However, in reality the LBO market has found ways round Article 23. A conclusion that can be drawn from this gap between appearance and reality is that in determining whether new measures should be added to the corpus of EC law in order more effectively to curb abuse and excess in LBOs, no-one should be under any illusion that there already is robust protection, in the form of Article 23.

Keywords: leveraged buyouts, European company and securities law, action plans, financial assistance

JEL Classifications: G30, G38, K22

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1. The European leveraged buyout market

1.1 A leveraged buyout (LBO) is a transaction in which a special purpose vehicle, a Newco, acquires a business mostly for cash. The Newco is established with a financial structure comprising a significant amount of debt and some equity. The equity component is provided by private equity firms that raise funds from investors in order to put them into suitable investment opportunities via Newcos.[1] The private equity fund will appoint a team of professional managers to run the Newco, which may be formed from existing managers of the buyout target.[2] One or more representatives of the investing private equity fund will typically join the board as a non-executive director. A private equity firm will look to exit the Newco at some point in order to realize its investment. Established exit mechanisms include trade sales, whereby the company is sold privately to another commercial company, secondary sales to another private equity firm and flotations. The majority of exits are achieved through trade sales and the flotation exit route tends mainly to be used for larger companies.[3]

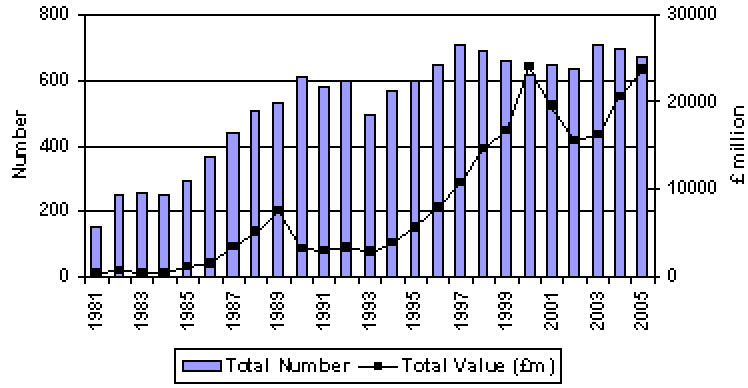
1.1 The UK buyout market first emerged in the 1980s and has been through periods of boom and decline in the years since then. In recent years, there has been an upwards trend in the size of transactions, although the overall number has fallen.

Figure 1 - Overall Trends of Buyouts/Buy-ins: UK

[1] P.S.SUDARSANAM, *Exit Strategy for UK Leveraged Buyouts: Empirical Evidence on Determinants* (February 2005). Available at SSRN: http://ssrn.com/abstract=676849

[2] Leveraged buyouts in which the new managerial team is formed from the existing management are also known as management buyouts: L. RENNEBOOG, AND T. SIMONS, *Public-to-Private Transactions: LBOs, MBOs, MBIs and IBOs*, (August 2005). ECGI - Finance Working Paper No. 94/2005 Available at SSRN: http://ssrn.com/abstract=796047. Management buy-ins are LBOs in which an external management team takes control: *ibid*.

[3] OXERA, *The London Markets and Private Equity-backed IPOs* (March 2006).



(Source: Centre for Management Buy-out Research at Nottingham University)[4]

1.2 On a country-by-country basis, the UK leads the European buyout market, in terms of both value and volume.[5] This is easily understandable given that securities market-based financing has traditionally been of much more significance in the UK than in Continental Europe, thus giving it a more established capital market on which companies that have been bought out may be floated at a later date (a process sometimes known as a reverse LBO),[6] a larger supply of publicly-quoted companies as buyout targets, the maturity of its M&A market and a wide array of sophisticated investors and advisers to effect such transactions.[7] By the same measurements (value and volume), France has the most active Continental European buyout market, followed by Germany.[8] On the basis of measuring buyout activity relative to GDP, the UK and Netherlands are ahead, followed by France and Germany, and with Spain and Italy having relatively undeveloped buyout markets on this measurement.[9] The value of the Continental European buyout market in 2005 has been put at around €89 billion (Figure 2) and for the whole of Europe (i.e. including the UK) at around €124 billion.[10]

Figure 2 - Trends of Buyouts/Buy-ins: Continental Europe

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[4] See further, M. WRIGHT, L. RENNEBOOG, T. SIMONS AND L. SCHOLES, *Leveraged Buyouts in the U.K. and Continental Europe: Retrospect and Prospect*, in (2006) 18 (3) *Journal of Applied Corporate Finance* 38.

[5] *Ibid*.

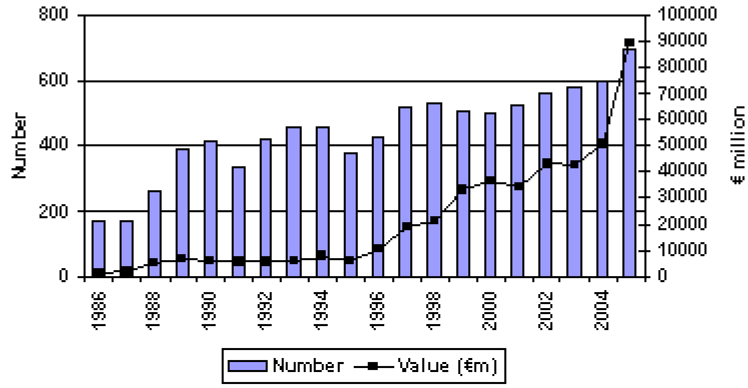
[6] F. DEGEORGE AND R. ZECKHAUSER, *The Reverse LBO Decision and Firm Performance: Theory and Evidence*, in (1993) 48 *Journal of Finance* 1323.

[7] M. WRIGHT, L. RENNEBOOG, T. SIMONS AND L. SCHOLES, *Leveraged Buyouts* (nt. 4), Table 6 which outlines factors affecting MBO market development in Europe.

[8] *Ibid*, Table 1.

[9] *Ibid*.

[10] *Ibid*.



(Source: Centre for Management Buy-out Research at Nottingham University)

1.3 Historically, the financing of European buyouts followed a different pattern from that in the U.S., with much less reliance on bonds and lower levels of leverage.[11] However, in recent years the debt-to-EBITDA (earnings before interest, taxes, depreciation and amortisation) leverage multiples of private-equity financed deals in Europe have risen to unprecedented levels.[12] High yield bonds and privately-placed loan instruments have become a more standard part of European buyout financing structures.[13] An illustrative specific example is provided by the December 2005 acquisition from Industri Kapital AB of Sydsvenska Kemi and its subsidiaries (together Perstorp) by the French private equity firm, PAI Partners, for approximately SEK9,422 million. The debt financing part of the deal structure was as shown in Figure 3.

Figure 3

Deal Structure

	Amount (m)	Terms	Net Leverage
Term Loan A	SEK2050	7 yr; 200bps	
Term Loan B	SEK2750	8 yr; 200bps	
Total	***SEK4800***		***4.0x***

[11] S. TOMS AND M. WRIGHT, *Divergence and Convergence within Anglo-American Corporate Governance Systems: Evidence from the US and UK, 1950-2000*, in (2005) 47 *Business History* 267, 276 – 279.

[12] G. TETT, *Leverage Multiples Reach Record Levels*, in *Financial Times*, May 25, 2006, p. 21.

[13] A. WILKINSON AND A. LUCAS, *High Yield Bonds: Raising the Stakes*, in (2003) 14(11) *Practical Law for Companies* 15.

Senior Debt			
Second Lien	SEK600	9.5yr; 550bps	4.5x
Mezzanine	SEK2,200	10 yr; 900bps	6.3x
Total Debt	***SEK7600***		***6.3x***
RCF	SEK500	7 yr; 200bp	
L/C Facility	SEK450	7 yr; 200bps	

(source: Goldman Sachs, *European LBO Market Update* Issue 61, 6 February 2006)

The equity investors, led by PAI funds, contributed cash equity, in the form of common equity and shareholder loans, representing approximately 23% of the total pro forma capitalisation.[14]

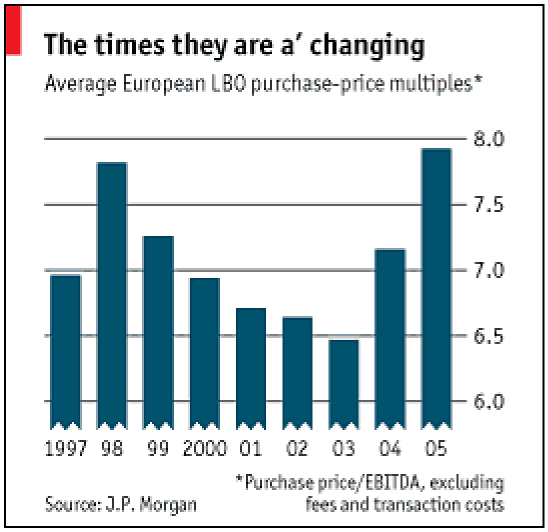
1.4 Figure 4 shows recent overall trends in European LBO purchase price – EBITDA multiples.[15] As well as significant increases in multiples, the European market is also maturing with respect to the range and sophistication of debt instruments that are in use, including multiple tranches of secured debts, “second lien” or “mezzanine” debt and high-yield bonds.[16] The deal structure of the Perstorp deal, detailed in figure 3, provides a typical example.

Figure 4

[14] GOLDMAN SACHS, *European LBO Market Update* Issue 61, 6 February 2006.

[15] Taken from *Barbarians at the Gates of Europe*, in *The Economist,* Feb 18, 2006, Vol 378, Issue 8465, p. 69.

[16] M. WRIGHT, L. RENNEBOOG, T. SIMONS AND L. SCHOLES, *Leveraged Buyouts* (nt. 4).



2 LBOs and value creation

2.1 Buyout activity is driven by the motivation to increase the value of the target company over the original purchase price.[17] A particular value-generating benefit associated with buyouts is reduced agency costs through active and close monitoring by the private equity investor of management's financial and operating performance.[18] The private equity firm can also add value through mentoring and knowledge transfer: it can act as a sounding board for managers' ideas and as a source of expert advice on matters such as optimising the company's capital structure and increasing operational effectiveness.[19] It can also facilitate better-quality management by installing new managers with strong business skills, qualifications and relevant experience.[20] The debt servicing obligations associated with high leverage can serve valuable corporate governance purposes by acting as a discipline on management.[21] High debt levels mean also that the benefits of tax deductibility of interest charges are increased.[22] LBOs are structured so as to give management a

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[17] A. BERG AND O. GOTTSCHALG, *Understanding Value Generation in Buyouts*, in (2005) *Journal of Restructuring Finance* 9.

[18] L. RENNEBOOG AND T. SIMONS, *Public-to-Private Transactions* (nt. 2); M.C. JENSEN, *Eclipse of the Public Corporation*, in (1989) 67(5) *Harvard Business Review* 61.

[19] A. BERG AND O. GOTTSCHALG, *Understanding Value Generation* (nt. 17).

[20] *The Charms of The Discreet Deal*, in *The Economist*, July 5, 2003, Vol 368, Issue 8331, p. 51

[21] M.C. JENSEN, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, in (1986) 76 *American Economic Review* 323.

[22] S. KAPLAN, *The Effects of Management Buyouts on Operating Performance and Value*, in (1989) 24 *Journal of Financial Economics* 217; L. RENNEBOOG AND T. SIMONS, *Public-to-Private Transactions* (nt. 2).

significant equity stake and this together with performance-related managerial incentives, such as stock options, provides incentives that can lead to valuable increases in operating income and margins and reductions in wasteful expenditures.[23]

2.2 Recent literature emphasizes financial arbitrage as a source of value generation in buyouts.[24] Private equity firms seek to generate value by exploiting differences in the valuation of the company at the time when it is acquired and the time of the subsequent divestment in an initial public offering or a trade sale that are independent of changes in the performance of the business.[25] Take for example, Celanese, a German chemicals company, which was taken private by U.S. private equity firm, Blackstone Group, in December 2003. Eleven months later Blackstone decided to float Celanese in New York thereby transforming its original investment of $650m into more than $3bn. The timing of the divestment decision was widely seen to have been strongly driven by arbitrage opportunities created by favourable market conditions that were exogenous to the financial performance of the company.[26]

2.3 A recent study of the post-IPO performance of nearly 500 companies floated by private equity firms in the period 1980 - 2002 found that the shares of those companies outperformed both the overall stockmarket and shares issued in other IPOs that were not backed by private equity.[27] However, the performance of the "quick flips"- the 53 companies that went public within a year after the LBO – was much worse than those companies kept longer than one year by buyout groups. The authors of the study noted that the differences were not statistically significant but they commented that the evidence provided partial support for the claim that "flipping" LBOs do not provide much value.

3 LBOs as a source of policy concern

Market abuse

3.1 Opportunistic exploitation of inside information was identified early on as a potential problem with management-led LBOs. Many studies have sought to investigate the significance of managerial manipulation of information as a driver of buyout activity

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[23] KAPLAN, *ibid*; A. BERG AND O. GOTTSCHALG, *Understanding Value Generation*, (nt. 17), provides a detailed literature review of LBOs as mechanisms for adding value through increasing operational effectiveness. EUROPEAN COMMISSION, *Report of Alternative Investment Group: Developing Private Equity* (July 2006), pp. 11 – 12 (incentive structures in investee companies).

[24] A. BERG AND O. GOTTSCHALG, *Understanding Value Generation* (nt. 17).

[25] *Ibid*.

[26] As noted in M. GOODMAN, *Pizza Quick Flip Stirs Up Trouble*, in *Sunday Times*, October 15, 2006, Business Section, p. 23.

[27] J.X. CAO AND J. LERNER, *The Performance of Reverse Leveraged Buyouts*, NBER Working Paper No 12626, (October 15, 2006). Available at SSRN: http://ssrn.com/abstract=937801

but the evidence is broadly inconclusive.[28] The maturity and sophistication of the modern LBO market, detailed disclosure and approval procedures associated with LBO transactions, the professionalism of vendors, the increased scrutiny of securities analysts, the reliance on open-auction style sale processes,[29] and the increasing incidence of LBOs that are not led by incumbent management are said to be factors that leave less room than might have been the case historically for managerial exploitation of inside information.[30] On the other hand, the size and complexity of many of the recent private-equity funded LBO transactions, which involve participants in public and private markets and considerable product sophistication, generate a large flow of price sensitive information that is open to abuse by persons within private equity firms or who are otherwise involved in transactions. A recent discussion paper by the UK Financial Services Authority (FSA) classifies market abuse in private equity transactions as a risk of high significance, taking into account both impact (the potential harm that could be caused) and probability (how likely the event is to occur).[31]

Bankruptcy and systemic risk

3.2 LBOs by definition are transactions involving hefty amounts of debt, relative both to the amount of equity put into the purchase price and also the future earnings capacity of the target. The benefits of adding debt to the balance sheet diminish as debt rises to an excessive level thereby making borrowers very vulnerable to interest rate rises and downturns in market conditions. The UK FSA has said recently that current leverage levels and developments in the economic/credit cycle mean that the default of a large private equity-backed company or a cluster of smaller private equity-backed companies "seems inevitable".[32] The FSA has also noted that the extensive use of complex risk transfer practices and of credit derivatives, whereby lenders take debt off their balance sheets, may exacerbate problems because such structures can obscure ownership of economic risk and may thus hinder efficient restructurings of financially distressed companies.[33]

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[28] A. BERG AND O. GOTTSCHALG, *Understanding Value Generation* (nt. 17), provides a review of the literature.

[29] On the operation of the sales auction process see D.J. COOKE AND J. DOW, *Private Equity: Law and Practice* (Sweet & Maxwell, 2nd edn., 2004) 12.

[30] A. BERG AND O. GOTTSCHALG, *Understanding Value Generation* (nt. 17).

[31] FSA, *Private Equity: A Discussion of Risk and Regulatory Engagement* (DP 06/6, November 2006).

[32] *Ibid*.

[33] *Ibid*.

3.3 Financial crises affecting bought-out companies that are carrying high levels of debt on their balance sheet could have repercussions for investors, many of whom are themselves highly-leveraged hedge funds or pension funds seeking higher returns from alternative investments to shore up shortfalls in pension provision. Negative repercussions at that level could have systemic implications. In a recent Green Paper, the European Commission raised the question whether from a market stability perspective the activities of either private equity or hedge funds might warrant particular attention.[34] It commented further that the possible implications of alternative investment strategies for investor protection and financial stability remained poorly understood.[35] The UK FSA has acknowledged that it is conceivable that in extreme circumstances financial stability and elements of the UK economy could be jeopardized by the consequences of financial failure of companies that are backed by highly-leveraged private equity financing.[36]

3.4 Excessive leverage and obscure ownership of economic risk are rated as risks of medium to high significance by the UK FSA.[37]

Public confidence and corporate governance concerns

3.5 It is something of understatement to say that LBO activity driven by private equity firms does not enjoy a universally favourable public reputation. In February 2007 *The Economist* magazine noted that “sharp criticism has become a daily nuisance for the private-equity industry”.[38] Private equity can arouse suspicion and unease, with its “private” dimension raising connotations of shady activity and collusion between very sophisticated operators. Companies owned by private equity firms operate free of the heavy burden of transparency-related disclosure to which quoted companies are subject and also from corporate governance constraints relating to particularly sensitive issues such as executive pay. The vast profits made by some private equity firms make them a target for criticism which can rise to high political levels. Mention can be made again here of the Blackstone/Celanese example which in 2005 provoked Franz Müntefering, the then chairman of Germany's Social Democratic Party, to describe private equity firms as "a swarm of locusts".[39]

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[34] EUROPEAN COMMISSION, *Green Paper on the Enhancement of the EU Framework for Investment Funds*, COM (2005) 314, p. 9.

[35] *Ibid*, p. 14.

[36] FSA, *Private Equity* (nt. 31).

[37] *Ibid*.

[38] *The Uneasy Crown*, in *The Economist*, Feb 10, 2007, Vol 382, Issue 8515, p. 74.

[39] J. WARNER, *Outlook: Deutsche Borse's Seifert is Devoured by a Plague of Anglo- American Locusts*, *The Independent*, May 10, 2005, p. 63.

3.6 Private equity firms sometimes come in for criticism for loading companies with debt and taking excessive fees and dividends. Rather than being creators of the kind of value that builds enterprises, provides jobs and yields associated economic benefits, private equity firms can be characterized as destructive short term operators. In a much publicized speech at the Davos Economic Forum in 2007, a leading trade unionist described the philosophy of private equity firms as being to: "buy it, strip it and flip it".[40] The speech continued:

> These deals are not about innovation but about buying at a good price and selling at a handsome profit. It is no longer true that you hold onto an investment for several years to try and make the business more efficient and then cash out. To many, it now looks like the priority is to pay yourselves hefty fees, hefty dividends and look to cash out when it suits you.
>
> …
>
> Debt levels are dangerously and unprecedently high…This results in exaggerated responses by the management of the companies concerned. Their priority: settle the debt. Your priority: take more debt to pay fees and dividends. It is like a slasher movie. You slash jobs, health, pensions, working conditions. This in turn impacts communities, services and customers, for whom you care little. The "deal" takes precedence. At a time when we are looking for companies to be more transparent, you are taking corporate governance underground. Does this mean you have abandoned any sense of broader responsibilities?

3.7 In a similar vein, another leading trade unionist gave a speech a few weeks later in which he described private equity firms of being "little more than amoral asset-strippers after a quick buck; casino capitalists enjoying huge personal windfalls from deals at the same time as they gamble with other people's futures."[41]

Conflicts of interest

3.8 Exiting investee companies at a favourable time is central to the business of private equity firms. This gives rise to a potential conflict of interest in that a private equity firm's assessment of the best time from its perspective for a flotation, or other form of exit, may not coincide with the company's interests and may, for example, lead to long-term problems because, from the company's viewpoint, that step was taken prematurely.[42] Other circumstances where the interests of the private equity firm may

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[40] Speech by Philip Jennings, General Secretary of UNI Global Union, available via http://www.union-network.org/UNIFlashes.nsf/0/F8B280D736E74DB3C125727A00524BD3 (accessed February 2007).

[41] Speech by Brendan Barber, the General Secretary of the TUC reported in C. ADAMS AND P. SMITH, *TUC Chief Attacks Private Equity Industry*, *Financial Times* 20 February 2007.

[42] D.J. COOKE AND J. DOW, *Private Equity: Law and Practice* (nt. 29), 18; P. GOMPERS AND J. LERNER, *The Venture Capital Cycle* (MIT Press, 2002) 19 – 20.

diverge from those of an investee company include where the firm sees advantages in allocating its limited expert management team resources to other companies in its portfolio[43]

3.9 There is also scope for material conflicts of interest between a private equity fund's own interests and those of the investors in the managed funds, and as between different groups of investors whose funds are under management. An example of a conflict of interest between a firm and its investors, which is mentioned in a recent report by the UK FSA, arises from the practice of key investment staff of private equity firms committing their own capital to the pool of funds under management. This is intended to ensure an alignment of interests but there is scope for abuse, such as where the staff can be more selective in their investments than other investors ("cherry picking") or are otherwise able to structure investments so as to favour themselves.[44] Lenders and deal advisers also face conflicts of interest, for example where they are advising on both sides of a private equity-funded bid or where they have several private equity clients that are competing with each other on a particular transaction. The UK FSA has noted that these risks are intensified where a potential bidder is the bank's in-house private equity fund (especially where it is investing proprietary funds).[45]

3.10 The FSA has ranked conflicts of interest alongside market abuse as a risk of high significance.[46]

Other concerns

3.11 Barriers to investment in private equity by retail investors and by some professional investors such as pension funds also give rise to policy concerns.[47] So too does the opacity of the market: access to investment data is limited and the non-standardised form of such information as is available impedes the process of making comparative assessments of the performance of investment funds and research analysis activity.[48] Market access and market opacity are rated as medium to low risks by the UK FSA. The FSA also considers the reduction of overall capital market efficiency that may result from the expansion of the private equity market and its

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[43] FSA, *Private Equity* (nt. 31), p. 73.

[44] *Ibid*, pp. 72 – 73.

[45] *Ibid*, pp. 74 – 75.

[46] *Ibid*.

[47] *Ibid*.

[48] *Ibid*.

potentially damaging effect on the quality, size and depth of the public markets but classifies this as a low significance risk.

4 Building an EU legal environment in which value-creating LBO activity can flourish

4.1 Pros and cons are present in all business activities. Policymakers always need to consider what they can do to contribute towards the creation of an environment in which economically worthwhile activity can take place but abusive conduct that is socially wasteful is curtailed.[49] Private equity-backed leveraged buyouts are not at all unique in this respect.

4.2 Applying the broad definition that is in common usage in Europe, private equity embraces venture capital for startup businesses and early stage companies, later stage expansion capital and management buyouts and management buyins.[50] One implication of this broad definition is that there is a vast range of issues that could be considered by policymakers who are keen to stimulate an environment in which value-generating private equity investment and LBO activity can flourish. In order to increase the demand for private equity investment, policymakers could look at re-engineering regulatory and fiscal requirements with a view to increasing the attractiveness of entrepreneurship. Particularly at the venture capital end of the private equity market, potential entrepreneurs may also be encouraged by relaxations in the severity of bankruptcy laws.[51] Company and takeover laws are also relevant in that where the prevailing rules allow the existing controllers of companies considerable latitude to protect themselves from hostile bids or are otherwise poorly disposed towards outside ownership, this can negatively affect LBO activity by reducing the number of companies that are viable targets and result in situations where too much money is chasing too few deals.[52] Potential LBO targets include family businesses facing succession issues,[53] non-core businesses within a large conglomerate,[54] and underperforming listed companies.

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[49] M. WOLF, *Barbarians at the Gates: The Balance of Pros and Cons*, in *Financial Times*, February 28, 2007, p. 17.

[50] EUROPEAN COMMISSION, *Report of Alternative Investment Group* (nt. 23), p. 9.

[51] J. ARMOUR AND D. CUMMING, *The Legislative Road to Silicon Valley* in (2006) 58 *Oxford Economic Papers* 596.

[52] P.A. GOMPERS, *Venture Capital Growing Pains: Should the Market Diet?*, in (1998) 22 *Journal of Banking and Finance* 1089.

[53] Family-owned businesses are sometimes described as the ‘backbone’ of the European economy, accounting for around 70% of jobs and contributing up to 65% of the GDP of EU Member States: EVCA, *Private Equity and Generational Change* (Research Paper, 2005).

[54] M. SABINE, *Corporate Finance* (LexisNexis, 3rd edn., 2003) 309.

4.3 On the supply side, private equity is classified as a type of alternative investment, which is illiquid and more risky than quoted equities and bonds but which offers potentially higher returns. Exit routes – that is the routes whereby providers of equity can finally realise their investment through a disposal of the shares in investee companies– are of crucial significance to the amount of capital flowing into private equity because investors need reassurance that they will be able to realise their investment at some point. Since IPOs are one of the important exit routes in respect of successful investments, a strong securities market is thus thought to be critical to the development of private equity-financed LBO activity.[55] Levels of investment in private equity can also be strongly affected by the taxation system[56] and by rules restricting the asset classes in which regulated institutional investors, such as pension funds, are permitted to invest.[57] Listing rules can impede investor access to private equity funds where they contain requirements with which private equity funds cannot easily comply. This has been an issue in the UK where the FSA's *Listing Rules* historically prohibited primary listed investment entities from exercising control of investees and required the boards of directors of listed investment entities to be independent of any external investment manager. The FSA has moved to revise these requirements by relaxing board independence and control requirements in ways that may facilitate the listing of private equity investment vehicles.[58]

4.4 Within Europe, the complex constitutional relationship between the central EU institutional bodies and Member States, embracing legal and political sensitivities about the matters that can be properly addressed at EU level rather than being left to Member States' discretion within their national systems, serves to constrain the European Commission, which is the instigator of EU-wide legislative proposals, in putting forward ideas for shaping a regulatory framework that is conducive to private equity and leveraged buyout activity. Sensitivities about the appropriate level for policy intervention were evident, for example, in the *Risk Capital Action Plan,*

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[55] R. GILSON AND B. BLACK, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, in (1988) 47 *Journal of Financial Economics* 47; L.A. JENG AND P.C. WELLS, *The Determinants of Venture Capital Funding: Evidence Across Countries*, in (2000) 6 *Journal of Corporate Finance* 241. But note P.A. GOMPERS AND J. LERNER, *What Drives Venture Capital Fundraising?*, *Brookings Papers on Economic Activity--Microeconomics* (July 1998), 149 (NBER Working Paper No 6906) (no finding that IPOs play an important role in creating liquidity in the venture sector and potentially affecting contributions).

[56] On the complexity of the European tax position see EUROPEAN COMMISSION, *Report of Alternative Investment Group* (nt. 23), pp. 25 – 28. Further on tax, see J. POTERBA, *Venture Capital and Capital Gains Taxation*, in L. SUMMERS (ed), *Tax Policy and the Economy* (MIT Press, Cambridge, MA, 1989); P.A. GOMPERS AND J. LERNER, *What Drives Venture Capital Fundraising?* (nt. 55), (changes in capital gains tax can increase demand for venture capital by entrepreneurs).

[57] P.A. GOMPERS AND J. LERNER, *What Drives Venture Capital Fundraising?* (nt. 55). Further on the relation between regulation and institutional investment in private equity: D.J. CUMMING AND S.A. JOHAN, *Regulatory Harmonization and the Development of Private Equity Markets*, in *Journal of Banking and Finance*, forthcoming Available at SSRN: http://ssrn.com/abstract=842964

[58] FSA, *Private Equity* (nt. 31), p. 92. The changes are to be implemented in the third quarter of 2007.

launched by the Commission in 1998 with a view to stimulating a new culture of entrepreneurship within the EU.[59] The *RCAP* identified a need for a differentiated political response and acknowledged that many of the key initiatives, such as in relation to taxation, would need to be taken by Member States rather than at EU level. More recent policy initiatives continue to recognise that it is at national level that key decisions about the tax and operating environment in which private equity develops are largely determined.[60] Even so, many of the new EU-wide laws that emanated from the *Financial Services Act Plan* (*FSAP*), [61] an ambitious initiative begun by the European Commission in 1999 that included proposals for EU measures that were identified as priorities in the *RCAP*, are ones that, broadly speaking, would be regarded as useful laws to adopt with a view to encouraging private equity-driven buyout activity to flourish. The Prospectus Directive,[62] the Transparency Directive,[63] the Market Abuse Directive[64] and the IAS Regulation[65] aim to make issuers whose securities are admitted to trading on EU regulated markets attractive to the international investment community by providing a mandatory disclosure framework that conforms to international good practice expectations. They also seek to streamline the processes for being admitted to trading and/or offering securities to the public and for Community-wide dissemination of information. They regulate against harmful conduct, in particular in the Market Abuse Directive, which bans insider dealing and other forms of market manipulation.[66] The European Commission identified public confidence in the integrity of the market as being vital for an embryonic single EU-wide securities market.[67] The Market Abuse Directive proceeds

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[59] EUROPEAN COMMISSION, *Risk Capital: A Key to Job Creation in the European Union* COM (1998) 552.

[60] EUROPEAN COMMISSION, *Report of Alternative Investment Group* (nt. 23), pp. 3, 22, 25 - 28.

[61] EUROPEAN COMMISSION, *Implementing the Framework for Financial Markets: Action Plan* COM (1999) 232.

[62] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJ 2003 No L345/64.

[63] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ 2004, No L390/38.

[64] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), OJ 2003 No L96/16, art 6.

[65] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, OJ 2002 No L243/1.

[66] Market Abuse Directive, arts 2 – 4.

[67] COM (1999) 232, p. 23.

on the basis that market abuse harms the integrity of financial markets and undermines public confidence in securities and derivatives.[68]

4.5 These Directives and the IAS Regulation seek to contribute to the better functioning of the internal market and also to help Community companies to compete on an equal footing for financial resources available in Community and world capital markets. In principle private equity-funded leveraged buyout activity could benefit in various ways from realisation of these aims: better-quality information that makes it easier to identify potential buyout targets; more straightforward processes for IPOs exits; and, generally, a deeper pool of investment capital. This is certainly what the European Commission is hoping for: commenting on the Prospectus Directive it has said that "it will be easier and cheaper to raise capital all over the EU on the basis of a seal of approval granted by a Member State regulatory authority. This will facilitate risk capital exits (IPOs) and the introduction of companies in high-growth stock markets."[69] However, the consequences are not necessarily wholly benign. For example, certain features of the international financial reporting standards regime which is mandatory under the IAS Regulation do not easily accommodate private equity fund structures, which is a concern for listed funds that are subject to the mandatory requirement to produce IFRS accounts.[70]

4.6 There is also at least the potential for private equity-financed buyout activity to receive a boost from the wide-ranging Markets in Financial Instruments Directive (MiFID),[71] which, among other matters, revises the 'passport' system whereby investment firms can offer their services on a cross-border basis without encountering administrative or legal barriers and revises the framework within which stock markets and more modern forms of multilateral trading facilities operate. There is an exemption for managers of collective investment schemes which will take some private equity firms outside the direct scope of the MiFID but engaging in certain activities, such as giving investment advice, could bring firms within it and those that are subject to MiFID will be subject to prudential requirements on capital adequacy.[72]

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[68] Market Abuse Directive, rec 2.

[69] EUROPEAN COMMISSION, *Implementation of the Risk Capital Action Plan (RCAP)* COM (2003) 654, pp. 23 – 24.

[70] EUROPEAN COMMISSION, *Report of Alternative Investment Group* (nt. 23), p. 6

[71] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ 2004 No L145/1.

[72] MiFID, art 2. FSA, *Asset Management Newsletter* (April 2006). The application of the MiFID and accompanying prudential requirements to private equity firms is considered by the UK FSA, *Private Equity* (nt. 31), pp. 82 – 85. For the capital adequacy regime for investment firms covered by MiFID see Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast), OJ 2006 No L177/201.

Although the MiFID could thus add to the regulatory burdens on the industry, if its broad aim of facilitating the integration of secondary markets in financial instruments is achieved this could yield significant benefits for private equity.[73]

4.7 A number of new legal measures revise the European framework for prudential regulation, a framework which seeks to provide safeguards against systemic risks and thus establish the public confidence that is generally necessary for financial markets to flourish. Of particular relevance in this context is the adoption of EU-wide prudential rules applying to pension funds, which seek to improve systemic security but at the same time also to facilitate investment in alternative asset classes.[74] These rules are contained in a Directive, which has as its broad general aim the establishment of an internal market for occupational retirement provision organised on a European scale.[75] The European Commission suggests that adoption of this Directive will provide additional opportunities to the risk capital industry.[76]

4.8 The UCITS Directive provides a passport for collective investment schemes falling within the scope of the Directive to operate on a pan-European basis so long as they have been authorised in one Member State.[77] At first glance, it might be supposed that a regulatory regime that is designed to facilitate the pan-European marketing of funds would be helpful in stimulating the supply of investment in private equity. However, UCITS funds are subject to investment restrictions that, generally speaking, make them unsuitable vehicles for private equity investment. The rules concerning the investment policies of UCITS are being relaxed[78] but save to a limited extent the structure of private equity funds still does not meet the UCITS eligibility criteria.[79]

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[73] The policy goals underlying the MiFID are outlined in EUROPEAN COMMISSION, *Proposal for a Directive of the European Parliament and of the Council on Investment Services and Regulated Markets, and amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC*, COM (2002) 625.

[74] Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the Activities and Supervision of Institutions for Occupational Retirement Provision, OJ 2003 No L235/10.

[75] Recital 6. J. HANLON, *Pensions Integration in the European Union*, in (2004) 29 *European Law Review* 74 traces progress towards achievement of this goal.

[76] EUROPEAN COMMISSION, *Implementation of the Risk Capital Action Plan* (nt. 69), p. 11.

[77] Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ 1985 No L375/3.

[78] For an overview of the revised regime, see D. ROUCH AND K. SMITH, *The UCITS Directive and the Single European Funds Market: a Case Review*, in (2005) 20 *Journal of International Banking Law and Regulation* 251.

[79] As acknowledged by the European Venture Capital Association in a response to a consultation paper from CESR: *Advice on Clarification of Definitions Concerning Eligible Assets for Investments of UCITS* (CESR/05-064b). The EVCA's response is available at http://www.evca.com/pdf/consultation_cesr2.pdf (accessed July 2006). For CESR's view on limited circumstances in which a UCITS can invest in closed

The UCITS regime did not feature prominently in the *FSAP* but it now under review. The Commission has suggested that there is no immediate compelling case for a fundamental legislative overhaul but it has suggested some refinements and also acknowledged that recent changes may not be the final word because the growing importance of this business implies a need for continued attention to modernisation and development of the EU legislative framework.[80] In principle it might possible to adjust the UCITS regulatory structure so as to accommodate more readily private equity funds but current thinking suggests an alternative way forward by means of the promotion of a commonly understood "private placement" regime to facilitate cross-border marketing and placement of private equity investments without triggering mandatory disclosure or conduct of business rules. This alternative approach appears to accord with the views of the private equity industry which has suggested that a private placement regime would ideally be developed on a non-legislative basis.[81] In its 2006 White Paper on Investment Funds, the Commission pledged to report to the Council and Parliament in autumn 2007 on the most effective means to establish a common approach to private placement.[82] The Commission is committed to working with CESR and the newly created European Securities Markets Expert Group to identify residual obstacles to a private placement regime that originate from national rules on product approval. It has acknowledged that there are no compelling investor protection reasons for national regulators to interfere in financial transactions involving professional investors who understood the risks associated with an investment and sees its role as being to work to "free up" cross-border transactions between designated counterparties, as long as they remain within the perimeters of a common private placement regime. The Commission believes that such arrangements can make an important contribution to the deepening of European markets for institutional products such as private equity investments.

4.9 Although the origins of the Takeover Directive long predated the *FSAP*,[83] adoption of that Directive was included as an objective of the Plan to provide a more rationalised organisation of corporate legal structure in the single market. The Directive aims to establish clarity and transparency in respect of legal issues to be settled in the event of takeover bids and to prevent patterns of corporate restructuring within the Community from being distorted by arbitrary differences in governance and

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end real private equity funds see CESR's *Draft Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS: 2nd Consultation Paper* (CESR/05-490b) paras 4.3 – 4.9.

[80] EUROPEAN COMMISSION, *White Paper on Enhancing the Single Market Framework for Investment Funds*, COM (2006) 686, p. 14; EUROPEAN COMMISSION, *Green Paper* (nt. 34), p. 10.

[81] EUROPEAN COMMISSION, *Report of Alternative Investment Group* (nt. 23), p. 6.

[82] EUROPEAN COMMISSION, *White Paper* (nt. 80), p. 13. The remainder of this paragraph is drawn from this section of the *White Paper*.

[83] The background is traced in A. JOHNSTON, *The European Takeover Directive: Ruined by Protectionism or Respecting Diversity*, in (2004) 25 *Company Lawyer* 270.

management cultures.[84] However, the heavily diluted form of the final version of this controversial measure arguably fails to do much to make corporate control more easily contestable.[85] According to a European Commission report on implementation of the Directive, which was published in February 2007, elements of this Directive may even result in the emergence of new obstacles in the market for corporate control. [86] The likely impact of the Takeover Directive as a facilitator of hostile LBOs is therefore uncertain.

4.10 As well as the *FSAP*, the Company Law Action Plan (*CLAP*), launched by the European Commission in 2003 and representing, in part, the Community's response to the international financial scandals typified by Enron and Parmalat, is a further source of legal change affecting securities markets and corporate activity.[87] The *CLAP* provided the contextual background for changes to the European regime for the oversight of auditors.[88] The *CLAP* also includes proposals relating to corporate governance and shareholder rights. Issues of corporate governance, broadly defined, are increasingly seen to belong at the heart of the European debate about the policy choices that need to be made with a view to encouraging the development of active, competitive markets which are attractive to investors and in which value-generative takeover, merger and acquisition activity can flourish.[89] It is also within the *CLAP* that proposals for reforming the Second Company Law Directive are being taken forward, although the first efforts in this area are disappointing modest.[90]

4.11 Whether in fact the *FSAP*, *CLAP* and related regulatory initiatives will help, hinder or be largely neutral in their effect on private equity and leveraged buyouts is an open question, and is likely to remain so for some time. Although a cursory

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[84] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, [2004], OJ L142/12, rec 3.

[85] *Business as Usual: The European Union Has Missed Another Opportunity to Make its Economy More Competitive*, in *The Economist*, Dec 2, 2004, Vol 373, Issue 8404, p. 11.

[86] EUROPEAN COMMISSION, *Report on the Implementation of the Directive on Takeover Bids* SEC (2007) 268 (February 2007).

[87] EUROPEAN COMMISSION, *Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, COM (2003) 284.

[88] EUROPEAN COMMISSION, *Proposal for a Directive of the European Parliament and of the Council on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC*, COM(2004) 177, p. 3. Directive 2006/43/EC on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC, OJ 2006 No L157/87.

[89] A. Borges, *Keynote Address*, Hearing on Future Priorities for the Action Plan on Company Law and Corporate Governance, Brussels, May 3rd,2006, available via http://ec.europa.eu/internal_market/company/docs/consultation/address_en.pdf (accessed July 2006).

[90] See Section 5, infra.

examination would suggest that the EU is on a sensible track in its legislative programme, at a more detailed level the picture is not so benign. The various plans have led to a complex and lengthy body of new law which the financial services industry is struggling to absorb. In its 2005 Annual Report, the European Venture Capital Association (EVCA), a body representing the interests of the venture capital and private equity industry in Europe, commented that the complexity of European and national regulatory and fiscal frameworks was producing an overload of regulation leading to increasing bureaucracy.[91] There are concerns that specific aspects of the new laws, such as those under MiFID, do not take account of the special features of the private equity industry and are inherently unsuitable in that context.[92] The industry does not seem to place as much faith in regulatory solutions as European officials have tended to historically; industry preferences are evident, for example, in the emphasis placed by the EVCA on best practice standards and public awareness campaigns, based on research showing the industry's significant involvement in job creation, employment and innovation in Europe,[93] as strategies for demonstrating to governments and the general public the contribution to the "common good" made by its industry.[94] The importance of industry standards is also emphasised in the report by a private equity Expert Group which was established by the European Commission to inform its thinking on possible ways to enhance the European framework for investment funds.[95] That Group's support for a non-legislative private placements regime for the cross-border marketing of a private equity funds is a further indication of industry preferences. The European Commission's recent White Paper on investment funds indicates that the Commission is listening carefully to these views. The White Paper represents something of a step change in policy attitudes by adopting a generally cautious approach towards imposing regulation in relation to investments targeted at professional investors and emphasising the importance of "freeing up" activity where the results of careful analytical work show this to be appropriate.

4.12 Of course the Commission cannot simply defer entirely to the industry's preferences as those preferences may not meet broader economic or societal concerns that underpin its regulatory agenda. There is now no doubt that EU regulatory policy

[91] D. Cooksey, *Letter from the Chairman*, in *Annual Report 2005* (EVCA).

[92] EUROPEAN COMMISSION, *Report of Alternative Investment Group* (nt. 23), p. 24.

[93] Report conducted on behalf of the EVCA by the Center for Entrepreneurial and Financial Studies, Technische Universität München, *Employment Contribution of Private Equity and Venture Capital in Europe* (November 2005).

[94] *Ibid*. This research has attracted some strong criticism: O. Gajda, *Venture Capital Study Met Harsh Criticism*, in *Financial Times*, February 28, 2007, p. 16. However, other empirical research also supports the view that the impact of private equity on employment is broadly positive: K. Amess, and M. Wright, *The Wage and Employment Effects of Leveraged Buyouts in the UK*, in (2007) *International Journal of the Economics of Business* (forthcoming).

[95] EUROPEAN COMMISSION, *Report of Alternative Investment Group* (nt. 23), pp. 20-1.

in relation to securities markets embraces far more than merely facilitating the construction of a single market and that it extends significantly into the field of ensuring market stability and investor protection.[96] Achievement of those goals is liable to be compromised if the risks inherent in private equity-backed LBOs are not effectively addressed. Measures such as the Market Abuse Directive and the MiFID (to the extent that it is relevant in this context) are of crucial significance in this regard.

4.13 Many of the risks that arise in relation to LBOs are ones that are in the realm of company and/or insolvency laws rather than capital markets regulation. Whereas it is only relatively recently that Commission officials began explicitly to use the rhetoric of investor protection in articulating the aims of its agenda with regard to regulation of the securities markets,[97] the role of regulation as a protective mechanism is well-established in the context of European company law and has a Treaty base.[98] It is to an aspect of this protection that we now turn.

5 Leveraged Buyouts and the Second Directive

5.1 A central aim of the Second Directive is to protect creditors' interests through a series of rules relating to the raising and maintenance of capital. The basic conceptual approach is that legal capital represents the creditors' security and that there is an important role for positive law to shield this security from erosion through distributions to shareholders. Hence core elements of the regime are that public companies must raise a certain minimum amount of capital and that distributions to shareholders in public companies must not reduce net assets to below the amount of the subscribed capital and any undistributable reserve. However, it is an off-shoot of the core regime that has most significance in relation to LBOs. Article 23 of the Second Directive, which contains the rule prohibiting public companies from giving financial assistance for the acquisition of their shares, appears to strike at the heart of LBOs because the economic structure of these transactions depends on being able to use the acquired company's assets as security for the debt financing incurred to effect the acquisition but the ban is (seemingly) a blanket impediment to using target company assets in that way. The underlying goals of financial assistance law, as embodied in Article 23, extend beyond creditor protection in that they also embrace protecting shareholders from abusive conduct by controllers in takeover situations.

5.2 The European buyout market has flourished in recent years in spite of the pan-European ban on the giving of financial assistance. How has this come about? Luca

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[96] N. MOLONEY, *Effective Policy Design for the Retail Investment Services Market: Challenges and Choices Post FSAP*, in G. FERRARINI AND E. WYMEERSCH, *Investor Protection in Europe* (OUP, 2006) 381.

[97] *Ibid*, at 387-8.

[98] V. EDWARDS, *EC Company Law* (OUP, 1999) 3 – 9.

Enriques has made the point that the sheer volume of private equity buyouts in Europe indicates that the hindering effect of Article 23 of the Second Directive cannot be as great as is often contended.[99] What has happened in fact is that ways have been found to limit the effect of Article 23 in relation to LBO activity. These techniques have emerged against a background that has shifted from viewing LBOs as invariably questionable transactions in which sharp operators play the market for corporate control with other peoples' money to seeing them in a much more benign light as at least potentially economically worthwhile, value-producing activities. Astute legal practitioners have contributed significantly by interpreting Article 23 restrictively[100] but such interpretations are often controversial and transactions that rely on them can therefore contain significant elements of legal risk.[101] National legislatures have also played an important role by clarifying their national laws in ways that are helpful to the conduct of LBO activity. Of course Member States must observe their Community obligations to implement Article 23 but, as hostility to LBOs has eroded under the influence of modern economic thinking on the operation of the market for corporate control, it seems that national lawmakers have either become increasingly confident that Article 23 is not comprehensive and that there is some room for manouvre at national level or have been willing to discount the risk of being liable to account for a technical breach of Community obligations because of the strong economic arguments against a blanket ban on LBOs. Some difficulties remain, however, even where there has been statutory intervention at national level and legal risk is not entirely eliminated. Furthermore, navigating into safe harbours and looking out for the problems that still remain continue to be complex exercises requiring specialist legal advice. Despite the growth in the market, the European Private Equity and Venture Capital Association continues to regard dealing with the consequences of the rules on financial assistance as a significant challenge for private equity investors and views countries with the least burdensome form of the rules as offering a much more favourable environment for buyouts, compared to countries with stricter prohibitions.[102]

5.3 One of the most important ways in which European LBO transactions are insulated from financial assistance concerns is through exploitation of the fact that private

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[99] L. ENRIQUES, *EC Company Law Directives and Regulations: How Trivial Are They?*, in (2006) **7** *University of Pennsylvania Journal of International Economic Law* 1.

[100] E. WYMEERSCH, *Article 23 of the Second Company Law Directive: The Prohibition on Financial Assistance to Acquire Shares of the Company*, in *Festschrift fur Ulrich Drobnig*, 725.

[101] J.A. LA CALLE, *Spain: Challenging the Prohibition on Financial Assistance in the Case of LBOs*, in (2002) 23 *Company Lawyer* 130 presents arguments to the effect that under Spanish law implementing Article 23 LBOs do not per se infringe the prohibition on financial assistance. The article makes it plain that the views expressed are not universally accepted.

[102] EVCA, *Debt Financing Structures* (Special Paper, 2004) available at http://www.evca.com/images/attachments/tmpl_9_art_69_att_857.pdf#search=%22EVCA%20financing%20structures%22 (accessed September 2006).

companies are not covered by the Second Directive. In the UK, for example, private companies were within the scope of the domestic ban on financial assistance that pre-dated the UK's accession to the European Community but when the Second Directive was implemented in 1981 the opportunity was taken to relax the ban so as to permit private companies to give financial assistance on certain conditions that were designed to ensure the maintenance of capital and to give shareholders a say in the decision-making process. This was known as the private company financial assistance "whitewash" regime. This relaxation of financial assistance law for private companies was identified as a key factor affecting the growth of management buyouts in the UK during the 1980s because it made it easier for buyout financiers to take security.[103] The Companies Act 2006 goes further and abolishes entirely the law on financial assistance in relation to private companies. Private companies remain subject to maintenance of capital requirements and thus care will still be needed to ensure that financial assistance given by a private company is not an illegal disguised distribution.[104] However, if there is the possibility of a maintenance of capital concern, recourse can be had to other provisions of the Companies Act 2006 that relax the maintenance of capital regime for private companies to the extent of permitting reductions of capital on the basis of a shareholders' special resolution supported by a solvency statement from the directors.[105]

5.4 The UK is not alone in having a more relaxed regime for private companies. Under German law conversion of the target from AG (public company) to GmbH (private company) status is one of the main ways of securing access to its assets as security for the acquisition financing.[106] Capital maintenance rules still apply and these have the effect of prohibiting upstream guarantees and security by a GmbH that would have the effect of causing net assets to fall below the registered share capital.[107] However, security granted in breach of the maintenance of capital principles in favour of an arms-length lender is generally not invalid.[108] The Netherlands has recently moved to amend its law so as to provide an exemption for financial assistance by private companies.[109]

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[103] M. STERLING AND M. WRIGHT, *Management Buyouts and the Law* (Oxford, 1990); M. WRIGHT, L. RENNEBOOG, T. SIMONS AND L. SCHOLES, *Leveraged Buyouts* (nt. 4).

[104] The law on disguised distribution stems from the decision of the House of Lords in *Trevor v Whitworth* (1887) 12 App Cas 409.

[105] Companies Act 2006, ss 642 – 644.

[106] EVCA, *Debt Financing Structures* (nt. 103), pp. 9- 10.

[107] *Ibid*.

[108] *Ibid*.

[109] D. VIETOR AND E. SCHUT, *Ambiguity Remains for Dutch Buyouts*, in (2006) 25 (6) *International Financial Law Review* 28.

5.5 Some countries that do not have more relaxed regimes for private companies (and which, for example in the case of Spain, apply financial assistance law very stringently to private companies)[110] rely on merger structures for addressing financial assistance problems in European LBO transactions. Where an acquired company is to be merged into an acquirer rather than remaining as a separate entity that is now a subsidiary within the acquirer's group, it is possible to argue that the target has disappeared into the merged entity and therefore anything done thereafter cannot be characterised as the giving of financial assistance by the target. However, the substantive effect of this type of merger is that target's assets are put to use as security for the acquisition financing and there is thus a risk that the merger might be characterised as an artificial transaction designed to avoid financial assistance law. After a period when there were divergent opinions from scholars on whether financial assistance law acted as a blanket ban on merger LBOs or merely required careful analysis on a transaction by transaction basis so as to catch artificial transactions and the courts delivered inconsistent rulings, Italy took the bold step of providing a specific statutory "safe harbour" from the law on financial assistance for LBOs that are structured as mergers provided certain conditions are met.[111] Even though this legislative intervention has not put a complete end to debate and it appears to be problematic in at least one significant respect – namely its application to reverse merger LBOs, where the acquirer is merged into the target, because it is not possible in these cases to argue that the entity providing the financial assistance is not the target – it has been largely welcomed as improving what was previously an area of considerable legal uncertainty.[112]

5.6 Spanish law has also developed an exemption for mergers, though in this jurisdiction the exemption is based on scholarly and practitioner opinion rather than legislative intervention. The conditions relating to publicity and expert opinions on which the Spanish exemption are dependent are in a broad sense similar to those stipulated in the Italian safe harbour. Some Spanish authors suggest that the merger exemption is permissible because the conditions are effective substitutes for the shareholder and creditor protection purposes intended to be served by financial assistance law, though

[110] In Spain there is an absolute prohibition against both share repurchases and financial assistance for private companies ("sociedades de responsabilidad limitada"). This matter is regulated in articles 39 to 42 of the Private Companies Act ("Ley de sociedades de responsabilidad limitada"), which was adopted in 1995. Art 40.5 makes it clear that a private company may not grant financial assistance in any circumstance and it does not permit the giving of financial assistance under certain conditions, as happens with the "whitewash" procedure in the UK. Nor does it provide exemptions in the private company context for bank lending or employee share schemes, and in these respects it is even more restrictive even than Article 23 of the Second Directive which does contain carve-outs in these cases. Italy also has an absolute prohibition (art. 2474 Codice Civile) against both share repurchases and financial assistance for private companies ("società a responsabilità limitata").

[111] M. SILVESTRI, *The New Italian Law on Merger Leveraged Buy-outs: A Law and Economics Perspective*, in (2005) 6 *European Business Organization Law Review* 101.

[112] *Ibid*.

they acknowledge a risk that this interpretation might not stand up in court.[113] They also rely on the argument that the target disappears into the acquirer and is therefore not the provider of the financial assistance. Reverse merger LBOs are not regarded as permissible under the Spanish exemption.[114]

5.7 A relatively new problem with which the European LBO market is starting to grapple from a financial assistance perspective is break fees.[115] Break fees are arrangements between a bidder and a target whereby a fee is payable by the target if a specified event occurs that prevents the takeover from going ahead. Break fees originated in the U.S. and have since spread to the UK and, to a lesser extent, continental Europe. Break fees give rise to a financial assistance problem under British law because the prohibition on financial assistance by targets that are public companies is viewed as being applicable even where the acquisition of shares does not in fact take place (i.e. the circumstances of an aborted transaction to which a break fee relates) and as being sufficiently broad as to catch fee payments. Their legality, which has not been tested in the courts, rests on market practice which views fees capped at one per cent of a target company's net asset value as "immaterial" and therefore outside the relevant limb of the domestic financial assistance law. Yet for a Belgian lawyer break fees would apparently give rise to no financial assistance problem because the ban is interpreted restrictively and non-recourse payments are not regarded as falling within its scope. French law seems to accept that break fees are permissible so far as financial assistance law is concerned on the grounds that they are payable only when no transaction takes place. The Dutch position is that in principle break fees do not constitute financial assistance by the target. However, break fees are seen as being at least potentially problematic under German and Spanish laws relating to financial assistance. In Spain the solution adopted in at least one transaction was for the shareholders of the target rather than the corporate entity itself to enter into the break fee arrangement.

5.8 There are various other structures and interpretative techniques that can be used to restrict the application of financial assistance law in relation to LBOs. One is that it is generally accepted that the payment of lawful dividends is not caught by financial assistance law. Thus in France, where a cautious interpretation of financial assistance law generally prevails, the payment of post-acquisition dividends is a key mechanism whereby target company assets can be made available for use in the repayment of the acquisition finance.[116] Dividends (and capital reductions) are also relied upon as a way round the constraints of financial assistance law in Danish corporate finance

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[113] EVCA, *Debt Financing Structures* (nt. 103), p. 22.

[114] *Ibid*.

[115] This paragraph draws on A. KAY AND L. FREESTONE, *Break Fess – the Issues* (Gleiss Lutz, Herbert Smith and Stibbe Briefing. January 2004).

[116] EVCA, *Debt Financing Structures* (nt. 103), p. 28.

practice.[117] Another technique is to channel the financial assistance through foreign company subsidiaries that fall outside the territorial scope of the relevant national law.

5.9 What conclusions can we draw from this overview of the implications of financial assistance law for LBO transactions? These are outlined in the following paragraphs.

Financial assistance law is a hindrance rather than an insurmountable hurdle

5.10 It is clear that financial assistance law, though a hindrance, is not necessarily an insurmountable hurdle standing in the way of LBOs. National legislatures and ingenious legal practitioners have sought to limit its scope but the market has flourished even in countries where the legal environment is relatively conservative. For instance France has a particularly active market for LBOs notwithstanding the fact that its law does not include the private company relaxations and merger exemptions that have emerged elsewhere. Even at the EU level it is now accepted that a blanket ban is not appropriate and that public companies should have some flexibility to provide financial assistance so as to increase flexibility with regard to changes in ownership structures.[118] The recent amendment to the Second Directive to provide a gateway procedure whereby public companies can give financial assistance so long as certain conditions are fulfilled is welcome as, in a broad sense, an endorsement of restrictive interpretations of the scope of financial assistance law that may encourage the spreading more evenly through Member States of a more robust attitude towards its scope. However, the amendment is otherwise disappointing.

5.11 In the final version of the amending Directive some of the more burdensome requirements attaching to the gateway procedure when it was first published in draft form have been dropped[119] but there is still a condition for ex ante shareholder approval for financial assistance on a transaction by transaction basis which has been said to be “unworkable in the context of most corporate transactions where financial assistance is an issue”[120] and a condition requiring investigation of the credit standing of counterparties which could expose directors to the risk of personal liability.[121] Furthermore, there has been added to the condition that the giving of the

[117] *Ibid*, p. 36.

[118] Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006 amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital, OJ 2006 No L264/32, rec 5.

[119] For criticism of the draft proposal see E. FERRAN, *Simplification of European Company Law on Financial Assistance*, in (2005) 6 *European Business Organization Law Review* 93.

[120] Department of Trade and Industry, *Directive Proposals on Company Reporting, Capital Maintenance and Transfer of the Registered Office of a Company: A Consultative Document* (London, March 2005), para. 3.4.2.

[121] *Ibid*.

financial assistance must not reduce net assets, the further requirement that the company must include, among the liabilities in the balance sheet, a reserve, unavailable for distribution, of the amount of the aggregate financial assistance. This additional condition, which is also found in the financial assistance laws of some Member States,[122] uses the same language as Article 22.1(b), on share buy backs and it appears to have been added as an anti-avoidance measure: that is, to prevent companies using the financial assistance gateway to fund an acquisition of shares in circumstances where buying them back directly could (though whether it would depends on how the shares are shown in the balance sheet)[123] trigger a requirement under Article 22.1(b) for a reserve of an amount unavailable for distribution to be included among the liabilities. Yet, even though achieving consistency with Article 22.1(b) explains the drafting, from an accounting perspective this condition is oddly worded – how can an amount be recorded as a "liability" unless there is an obligation to pay someone? More fundamentally, this condition reinforces the sense that the gateway is really only a very tentative first step towards a more relaxed approach towards financial assistance at the EU level. Under the old British whitewash regime for private companies (which is a useful regime to refer to in this context because there are certain superficial similarities between it and the Directive gateway procedure), companies that had net assets were permitted to give financial assistance so long as any reduction in net assets was covered by distributable profits. In the case, for example, of financial assistance in the form of a loan to a counterparty with a strong credit rating, since the loan merely had the effect of substituting one asset for another, it had no implications with regard to distributable reserves. However, under the Directive, the condition appears to have the effect of requiring an increase in undistributable reserves by the amount of the loan, even where there is minimal risk of default. Moreover, unless a decidedly purposive interpretation can be adopted, the increase in undistributable reserves appears to be permanent, which is clearly an excessively cautious result if one thinks of the example of a loan which is duly repaid in accordance with its terms.

5.12 All told, the onerous conditions under which the Directive gateway is available suggest that it is unlikely to be much utilized by companies. But if it is correct to suggest that individual Member States are taking a more robust attitude towards the scope of financial assistance law in their domestic environment, why is that attitude not starting to make its presence felt more strongly at the European level? This is puzzling and only those with an insider view on the dynamics of the complex negotiations that can lie behind the adoption of EU laws would be qualified to

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[122] For example, the creation in the debt side of the balance sheet of a non distributable reserve amounting the value of the aggregate financial assistance is already a legal condition that has to be fulfilled according to art. 81 of the Spanish Companies Act (Ley de Sociedades Anónimas) when giving financial assistance in the context of the exemptions established for banks and employee share schemes. For criticism of this requirement in the Spanish context see A. VAQUERIZO ALONSO, *Asistencia Financiera para la Adquisición de Acciones Propias* (Ed. Civitas. Madrid, 2003) 465-470.

[123] UK practice is for treasury shares to be shown as a deduction from shareholder funds rather than as an asset with the consequence that Article 22.1(b) does not apply.

answer it properly. However, here is a thought experiment: although financial assistance law is now recognized to be too blunt an instrument, some of the problems that it was intended to solve are still a source of regulatory concern; these problems have a variable impact from country to country depending on general economic conditions and specific features such as corporate ownership patterns and tax laws that can drive the commercial structure of corporate transactions; this leads to diversity in national responses to the containment of financial assistance law and the development of appropriate alternative safeguards; and, in turn, this divergence makes it hard to establish common ground on which to build meaningful reform when the issue comes to be debated at the EU level, whilst the fact that the overall practical impact of financial assistance has been muted reduces the incentives to do so. The conclusions that are developed in the reminder of this section are broadly consistent with this view.

Working round financial assistance law is a technically complex exercise

5.13 The second conclusion is that working out the details of what is permissible by way of the giving of financial assistance under the various different national regimes and market practices remains a technically complex issue requiring specialist legal advice. Even on the core question – what is the exact scope of the law on financial assistance? – there are different responses across Europe, as is illustrated by the variation of approach in relation to break fees. The most pressing problems and the most effective solutions vary from country to country because the determination of priorities is influenced by other elements of national law and by local market practices. For instance, the fact that merger LBOs are a significant part of Italian acquisitions market practice appears to be crucial in understanding why the Italian legislature has seen fit to provide a specific exemption in respect of them, whereas the fact that French company and tax laws severely restrict the opportunities for mergers[124] may explain why shielding mergers from financial assistance law is much less of an issue for French law. Financial assistance law thus continues to add to transaction costs. How significant is this concern? The study on possible alternatives to the Second Directive capital maintenance regime which has been commissioned by the European Commission[125] may shed some light on this question but a pragmatic suggestion is that the element of the costs relating specifically to financial assistance may often not be that great when viewed in the context of the general complexity and the overall size of many private equity-funded LBOs. After all it is hardly as if it is a new problem that can only be resolved by developing expensive new legal technology from scratch. Whilst innovative transactions may lead to some refinement of the technology, in the main transactional lawyers will be working well within familiar territory when advising clients on financial assistance problems and on

[124] EVCA, *Debt Financing Structures* (nt. 103), p. 28.

[125] In 2006 the Commission awarded to KPMG, the accountancy firm a contract to carry out a study on the viability of an alternative capital regime. The study is expected to be finalised in May/June 2007.

the structures and steps that can be taken with a view to avoiding them. Yet it does need to be acknowledged that the magnitude of costs may well vary from country to country depending on the relative ease with which it is possible to side-step the financial assistance problem.

Residual legal risks associated with financial assistance law

5.14 Some elements of legal risk relating to financial assistance remain in spite of the efforts of national legislatures, legal practitioners and the academy. There is a risk that a national court might strike down an established market practice for shielding a transaction from financial assistance law on the ground that it rests on too restrictive an interpretation of the domestic law. The possibility of national laws that restrict the scope of financial assistance law being held to be incompatible with Article 23 of the Second Directive also cannot be overlooked. A further risk is that a transaction is not necessarily home and dry even when it is covered by a legally secure safe harbour from financial assistance law because the giving of the assistance may be held to infringe maintenance of capital requirements. This last point has been brought home to British lawyers as a result of the repeal of the ban on financial assistance by private companies. Whereas under the old "whitewash" regime private companies could give financial assistance only subject to an express condition relating to the maintenance of distributable reserves, the express conditionality falls away under the outright repeal of financial assistance law for private companies by the Companies Act 2006. However, in the absence of a provision overriding maintenance of capital principles in relation to the giving of financial assistance by private companies, which was pressed for during the passage of the Companies Act 2006 but rejected by the government which saw no reason to go that far,[126] the deregulatory effect of the change in the law is less significant than may have been appreciated when it was first announced. Concern about uncertainties in British law on disguised distributions may mean that cautious practitioners will interpret the freedom for British private companies to give financial assistance as being de facto still subject to the constraint that any reduction in net assets must be covered by distributable reserves or else be authorized as a reduction of capital. This would make the British position similar to that in Germany where lawyers appear to be accustomed to applying capital maintenance rules in relation to private company transactions involving what a British lawyer would recognize as potential financial assistance problems.

5.15 Markets do not like uncertainty but an element of legal risk is inevitable in dynamic, innovative conditions and the strong recent growth in European LBO activity demonstrates that the risks flowing from financial assistance concerns are ones that, generally speaking, the market has found it possible to absorb. This is just as well

[126] HANSARD, 20 March 2006, cols GC22 – 25 and HANSARD, 20 July 2006, Standing Committee D, cols 864 – 865. However, the government has pledged to make it clear in transitional provisions that that the removal of the prohibition on private companies giving financial assistance for a purchase of own shares will not prevent private companies entering into transactions which they could lawfully have entered into under the "whitewash" procedure: HANSARD, HL Vol 686, 2 November 2006, cols 443 – 444.

given that fundamental reform of financial assistance law is inextricably linked with radical reform of the entire Second Directive and there is no immediate prospect of that. Piecemeal reform is liable to be rather ineffectual if the recent amendment to Article 23 is anything to go by. Even though there is no good reason to keep financial assistance law which is a prime example of the "primitive regulatory technology" that, as my colleague John Armour has argued, characterizes the Second Directive as a whole,[127] living with a crude instrument is not so bad (at least at the mega-transaction end of the market where absorbing the costs associated with sidestepping it is not so difficult) when much of its power has been emasculated by creative analysis that draws legitimacy from the evolution of economic thinking that no longer sees it as always "highly improper" [128] for a syndicate to take over a company, appoint its own directors and then use the company's assets to restructure the acquisition financing. However, there is one potentially significant transaction-impeding risk that results from the uncertainty surrounding the legality of transactions that may appear to involve some form of financial assistance and which may not be avoidable by paying clever lawyers to devise ingenious structures. This is that financial assistance law has a nuisance value that can be exploited in hostile takeover situations by the commencement of litigation as a tactical ploy, not necessarily with a view to winning the case but simply to hold up the transaction for long enough to undermine its commercial rationale. Financial assistance is a good area to choose for this purpose because the uncertainties surrounding it mean that it is likely to take the Court a considerable amount of time to come to conclusion. The point is illustrated by the hostile takeover bid launched in 2005 by Gas Natural (the biggest Spanish gas utility company) over Endesa (the largest electricity supplier in Spain), where a suit was filed in the Spanish courts on grounds that included alleged contravention of the financial assistance prohibition, which led to the whole transaction being frozen by a preventive order for a considerable period of time.[129] In 2007 Gas Natural dropped in its bid leaving a rival bidder, the German utilities company E.ON, in the fray.

Financial assistance law is a potentially harmful distraction in the policy formation process

5.16 The final conclusion in this section involves a return to fundamentals. From a company law perspective (which provides only a partial glimpse of the risks posed by the phenomenal growth of private equity-funded LBOs), classic agency problems are inherent in LBOs: managers who are liable to promote their own interests over

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[127] J. ARMOUR, *Legal Capital: An Outdated Concept?*, in (2006) 7 *European Business Organization Law Review* 5, 27.

[128] This is a quotation from the British Greene Committee, in whose 1926 Report lie the origins of the European law on financial assistance: *Company Law Amendment Committee Report* (Cmd 2657, 1926) paras 30 – 31.

[129] R. MCLEAN, *Gas Natural Bid for Endesa Faces New Hurdles*, in *International Herald Tribune* March 22, 2006.

those of the general body of shareholders; majority shareholders who are poised to exploit minorities; and controllers who may load their company with a heavy additional debt burden that could threaten the interests of the existing creditors and of employees. There are difficult questions about the range of regulatory and governance strategies that can best address these concerns. The debates at national level recognize this. For example, the recent move by the UK to abolish financial assistance law completely for private companies was not taken because British policymakers decided that there was no need for protective regulatory intervention to achieve the goals that underpin financial assistance law but rather because they concluded that general company law on directors' duties and minority protection, takeover regulations and insolvency laws could be relied upon instead to perform that function. The Italian mergers LBOs safe harbour provides another example. This is subject to conditions relating to disclosure and the involvement of independent gatekeepers that employ some of the most well-known regulatory strategies for addressing agency problems. Insolvency laws that allow for the unwinding of undervalue transactions made by companies in financial difficulties have particular significance in this context.[130] Of course there is room for a difference of views on the effectiveness of these various strategies but all of them are superior to financial assistance law, which, as we have seen, has been largely sidelined as a controlling mechanism, and which, in any case, is too blunt an instrument to address properly the various complex and multi-faceted concerns raised by LBO transactions. Seen in this light, an inescapable conclusion is that financial assistance law commands disproportionate attention and is arguably liable to distort the policy formation process. Figuring out what response (if any) is needed at the regional (EU) level to address the agency problems that are inherent in LBOs is a hard enough task on its own without the distraction of financial assistance law on the side.

6 Conclusions

6.1 Private-equity funded LBOs form a booming segment of European market activity. Capital has flowed into private equity because worldwide economic conditions have provided investors with large amounts to invest and for which they are seeking returns greater than are available from the public markets. In recent years private equity funds have outperformed other asset classes.[131] The growth of private equity-funded buyout activity in Europe also owes much to the fact that it is a maturing business segment that is benefiting from a track record of achievement by private equity firms. The phenomenon of success building on success - the higher the amounts already invested the easier fund managers raise new funds in a given country

[130] D.G. BAIRD, *Legal Approaches to Restricting Distributions to Shareholders: The Role of Fraudulent Transfer Law*, in (2006) 7 *European Business Organization Law Review* 199. Baird suggests a similarity between the prohibition on financial assistance and the operation of U.S. fraudulent conveyance law in connection with LBOs: *ibid*, 201, note 6.

[131] EUROPEAN COMMISSION, *Report of Alternative Investment Group* (nt. 23), p. 18.

– has been identified in Europe.[132] This is consistent with U.S. market data showing that reputation and past performance are important determinants of fundraising.[133]

6.2 Given the role that private equity can play in channelling investment capital into the corporate sector and in providing attractive investment returns to institutional investors it is unsurprising that there is a deepening interest in it among European policymakers. To assist it in forming the policy agenda for investment funds that is set out in its 2006 White Paper, the European Commission established an expert group to inform it specifically about private equity. The experts told the Commission that private equity makes an: "important contribution to the re-generation of the economy by nurturing new enterprises and re-energising existing companies. In so doing, it can lay the seeds for sustained growth and job-creation and assist in the drive to be increasingly globally competitive." [134] This type of language is music to the ears of the Commission which has the development of deep, liquid, dynamic financial markets to ensure the efficient allocation and provision of capital and services throughout the European economy deeply ingrained in its psyche.

6.3 The levers that need to be pulled in order for Europe to have a "private equity friendly policy framework"[135] are distributed between national and regional actors. For the policymakers at these various levels, the challenge is to maintain a balance between competing considerations regarding the benefits and dangers of highly leveraged activity and the running of major companies outside the transparency constraints of the public markets so that economically worthwhile activity can take place but abusive conduct that is socially wasteful is effectively curtailed. At EU level there has been a marked preference for new legislation as the mechanism for achieving policy goals in relation to financial markets, although this is starting to change. However, well-intentioned legislation can have unintended adverse consequences and, even where new requirements are fundamentally sound, the adaptation process can generate upheaval and costs that are not necessarily off-set by the benefits gained. This article has reviewed a selection of recent new EC laws which, though not necessarily conceived with the needs of the private equity market segment specifically in mind, may have significant repercussions for it. It will some time to gauge whether in substance the new laws make a valuable contribution to the policy framework but it is already clear that they entail significant adaptation costs. To the extent that regulation can seek to play a facilitative role it is with some justification that private equity experts can doubt the overall value of "intrusive regulatory involvement";[136] after all their industry did not need to wait for the FSAP or other

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[132] M. BALBOA AND J. MARTI, *Determinants of Private Equity Fundraising in Western Europe* (April 2001). EFMA 2001 Lugano Meetings. Available at SSRN: http://ssrn.com/abstract=269789.

[133] P.A. GOMPERS AND J. LERNER, *What Drives Venture Capital Fundraising?* (nt. 55).

[134] EUROPEAN COMMISSION, *Report of Alternative Investment Group* (nt. 23), p. 2.

[135] *Ibid*, p. 3.

[136] *Ibid*, p. 2.

regulatory programmes to achieve the dramatic growth in the European market for private equity-financed LBOs reviewed in this article. In so far as regulation is intended to act as a disciple that curbs abuse, the effectiveness of the new measures has yet to be stress tested.

6.4 A particular cause for concern is that once a regulation has been adopted it can prove hard to shift even where it has become clear that it is impeding economically worthwhile transactions. The experience with Article 23 of the Second Company Law Directive gives credence to such concerns. Financial assistance law is a feature of the policy framework affecting LBOs that has proved to be quite resistant to effective change at the EU level. The fact that the market has worked out ways of living with financial assistance law, helped some moving of policy levers by national legislatures to facilitate private equity-financed LBO activity, is only an imperfect solution. Problems remain, not least of which is the scope for uncertainties about financial assistance law to be exploited in tactical litigation designed to disrupt hostile bids.

6.5 Also problematic is the gap between appearance and reality. In Article 23 Europe appears to have a rule that addresses creditors' interests in a manner that is functionally akin to U.S. fraudulent conveyance law.[137] However, the reality is that in many European countries there are many circumstances in which it is relatively easy to bypass Article 23, especially post-acquisition when target companies are taken private. It is not the purpose of this article to consider whether new measures should be added to the corpus of EC law in order more effectively to curb abuse and excess in LBOs that could be detrimental for creditors (and also employees). This article simply notes that it is clear that no-one should be under any illusion that there already is robust protection, in the form of Article 23, and that therefore there is no need for further regulatory intervention in this area.

[137] D.G. BAIRD, *Legal Approaches* (nt. 130), makes this link.

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