International investors have confronted German corporate governance head on, recently forcing the resignation of the Deutsche Borse's chairman. Andreas Nelle explains German attitudes to corporate governance and how outside investors are ultimately bound by the German rules of the game

Corporate rebels

As foreign private equity and hedge funds enter the German market in record numbers to reshape industry structures and market strategies, their 'rebellious' notion of corporate governance is bound to clash with traditional German attitudes, as manifested in business practice and law.

While the German Government has taken action to remodel corporate law upon international standards, enraged outcries have recently called for stricter regulation of foreign investors, to protect German companies and workers, likening foreign financial investors to locusts devastating the German corporate landscape. This "socialist nonsense", as US investor Guy Wyser-Pratte said while repudiating Germany's Social Democrat chairman Franz Muentefering's comparison in a SPIEGEL interview, itself fed upon the much-publicised corporate governance battle involving the UK hedge fund The Children's Investment Fund Management (TCI) and the German stock exchange Deutsche Boerse (DB).

The massive share buyback announced by DB after the corporation's failed attempt to take over the London Stock Exchange (LSE), along with the resignation of its CEO Werner Seifert and the overhaul of its supervisory board, impressively illustrate the power of active shareholders. However, TCI's triumph may turn out to be a Pyrrhic victory, as the German financial regulatory agency Bundesanstalt fur Finanzdienstleistungsaufsicht (BaFin) is currently investigating whether the fund's influence was based upon coordinated action with other DB investors, which would trigger significant consequences under German law.

Reuters

Forced out: Werner Seifert

> The press soon commented that Seifert's shareholder committee was corporate governance 'turned on its head', undermining the supervisory board's accountability and dividing shareholders into separate classes

TCI buys into DB

When DB announced a conditional takeover offer in December 2004 at 530 pence per LSE share, TCI began purchasing DB shares until it owned 5.01% in mid-January, exceeding the 5% disclosure requirement threshold under German law. TCI would later explain its move by noting that DB stock was extremely cheap due to its history of "value-destroying transactions".

Not long after his fund's first appearance in public, TCI boss Christopher Hohn openly demanded that the LSE offer, which he considered too high, be subjected to the vote of an extraordinary shareholders' meeting and announced a motion for a stock buyback. However, Hohn did not realise that German law prevented him from exercising the minority shareholder right of demanding a shareholders' meeting, since he had not held the required 5% for at least three months.

Nevertheless, the fund soon gathered support from fellow 'rebel' shareholder Atticus (6% holding) as well as established investors, such as Fidelity (10%) and Merrill Lynch (3%-4%), and gradually increased its own stake to a peak of 7.9% in May, making the DB investment a large share of its portfolio.

With stakes so high, Hohn demanded that both Seifert and Rolf Breuer, chair of DB's supervisory board, step down, deeming their presence inconsistent with his goal of maximising the value of DB and claiming by early March that investors holding between 42% and 43% were publicly supporting his designs.

Contacts:

Luís Sáragga Leal
lsl@plmj.pt

Francisco de Oliveira Martins
fom@plmj.pt

José Miguel Júdice
jmj@plmj.pt

Lisboa (Head Office)

Edifício Eurolex
Av. da Liberdade, 224
1250-148 Lisboa
Tel. +351 21 319 73 00
Fax. +351 21 319 74 00

Local Offices:
Porto
Algarve

OUR LAWYERS SHARE A COMMITMENT
TO UNDERSTAND THE SPECIFIC NEEDS OF EACH CLIENT

Independent comprehensive assistance in all fields of law and an in-depth knowledge of the business and economic environment from a domestic and international perspective are our trademarks since 1968.

Professional quality generated by a demanding work environment and the academic and professional enhancement of our lawyers have always been PLMJ's fundamental values, resulting in consistent international recognition both for PLMJ and its lawyers.

All our lawyers share a commitment to understand the specific requirements and needs of each client as an essential pre-requisite for the most efficient advice.

A.M.PEREIRA, SÁRAGGA LEAL, OLIVEIRA MARTINS, JÚDICE E ASSOCIADOS
SOCIEDADE DE ADVOGADOS, RL

International Offices: Brazil, Angola and Macao (in joint venture with local Firms)
E-mail: plmjlaw@plmj.pt - Website: www.plmj.com

Messy affair: DB's failed attempt to take over the London Stock Exchange resulted in the overhaul of DB's supervisory board

DB withdraws LSE offer

With the DB stock continuously rising, the DB supervisory board announced on 6 March that it would withdraw its conditional offer, ostensibly since LSE had not recommended the takeover, and distribute "significant amounts" to its shareholders. In particular, DB would proceed to buy back up to 10% of its shares (but spend no more than the €448.4m (£310.8m) surplus reserve intended for the takeover, as stipulated by German law) until its May AGM and would distribute a total of €800m (£554m) in 2005.

Yet TCI continued to demand the replacement of a majority of the supervisory board, claiming that Breuer had neglected to inform board members of the hedge fund's views and charging him with a conflict of interest due to his chairmanship of the Deutsche Bank supervisory board which had been retained to arrange the financing for the LSE transaction.

In response, Seifert addressed a public letter to Hohn, reprimanding his plan as "change for the sake of change itself" and chiding him for the "public spectacle" he was conducting.

DB announces shareholder committee

Seifert also offered a corporate governance programme that would set up a shareholder committee, but explicitly rejected any personnel changes in advance of the scheduled 2006 board elections. With 10 members, who would be recruited in equal proportions from UK, US and continental European institutional investors, the shareholder committee was to advise the executive and supervisory board regarding the selection of board members and issue recommendations regarding extraordinary corporate transactions.

The press soon commented that Seifert's shareholder committee was corporate governance "turned on its head", undermining the supervisory board's accountability and dividing shareholders into separate classes. Such a committee would not only violate the equality principle of German corporate law but would also raise the serious issue of members exerting significant influence without facing liability.

Even so, Seifert's letter did not tame TCI, so he fired out a follow-up, charging Hohn with "damaging the reputation of the company and its executives" and asking him whether he "intend[ed] to compensate other shareholders for [his] controlling influence over board decisions", a challenge that was to cause serious trouble down the line.

Management shake-up

With all its efforts in vain, DB announced in early May that Seifert would immediately resign, that three members of the supervisory board would join Lord Peter Levene, who had already stepped down in late April, and that Breuer would leave office by the end of 2005. However, as the DB heads did not give in to the demand that the supervisory board be replaced immediately and refused to put the strategic option to acquire LSE to vote at the AGM, Hohn made use of his 5% shareholder rights to put a vote to oust Breuer on the AGM agenda.

Ultimately, although TCI dropped its proposal two days before the AGM, and although the discharge vote resulted in a 68% approval for executive and supervisory board members, the hedge fund's desire to shape DB's market strategy and influence its personnel decisions had an immense effect on the course taken by the corporation, which highlighted a clash of disparate conceptions of corporate governance.

Underlying issues

German law vests the authority to make independent decisions in the executive board of a corporation, which is why Seifert had no reason to request AGM approval for his plan to take over LSE. The executive board is supervised by a strictly non-executive supervisory board, elected by shareholders. Only in very limited circumstances must the executive board ask the shareholders directly for approval. The German Federal Court's Gelatine ruling in 2004 clarified this, following the 1982 Holzmuller case, which had held that management could not transfer more than 80% of its operations to a subsidiary without AGM authorisation.

Gelatine clarified that AGM approval is required only for decisions which have such a significant impact that their validity is tantamount to a change in a corporation's articles of association. In such cases, a three-fourths vote is necessary for approval. And while Gelatine did not consider takeovers *per se*, it is widely read to imply that only radical changes in a corporation's structure, such as perhaps the acquisition of a very substantial business vastly different from the buyer's own, would require shareholder approval.

Acting in concert

And yet, despite the legal authority of DB's management, TCI was able to exert sufficient pressure to steer the corporation away from LSE and have Seifert step down. Mainly the fund's repeated allegations that a large group of shareholders joined in its opposition built its strong bargaining position. That potential power, however, prompted BaFin to investigate whether the rebel shareholders' behavior constituted "acting in concert".

In general, 'acting in concert' refers to shareholders co-ordinating their actions in respect of a corporation and employing an agreement or any other means in order to influence it in a substantial and enduring way. In a case of 'acting in concert', the involved shareholders' stakes can be mutually attributed. Should a shareholder's stake exceed 30% after attribution, he legally assumes control over the corporation, in which case German law requires him to disclose his stake within seven days and meet a four-week deadline for submitting a tender offer to all shareholders. Failing to follow these requirements carries high sanctions—a fine of up to €1m (£693m) payment of default interest, as well as loss of shareholder rights for the duration of the breach (including voting rights at the AGM).

BaFin is currently investigating whether TCI acted in concert with other shareholders and while certain indications do exist, conclusive proof will be difficult to establish. Nevertheless, foreign shareholders should be on guard for the agency, since German law encompasses a wider range of activity under the concept of 'acting in concert' than, for example, the British City Code, which is limited to investigating concerted acquisitions of shares. In fact, contrary to US-based investor Peter Schoenfeld, who had traded on the expectation that three German companies acted 'in concert' in their acquisition of 32.6% of Beiersdorf's shares, BaFin held that mere concerted acquisition did not suffice for establishing 'acting in concert', unless the buyers had long-term designs to influence the target. The case is currently pending before the Higher Regional Court of Hamburg.

Although an extraordinary case, *TCI v DB* is not unique, as evidenced by the resignation of Hans Fahr, CEO of IWKA, early last month under pressure from the corporation's second largest shareholder Guy Wyser-Pratte (6.3%). Indeed, IWKA's AGM was even more dramatic than DB's, as shareholders voted not to discharge the supervisory board and Wyser-Pratte's counter-motion to vote no-confidence in the executive board succeeded. Similarly to the TCI case, BaFin announced that it did not rule out investigation of Wyser-Pratte's behavior.

The increased interest among international investors in targeting Germany's corporations will continue to lead to conflicts, both among shareholders and between management and shareholders, many of which will take German law as their final arbiter. While on the business level 'rebel' shareholders wield sufficient influence, they must still abide by the rules of the game in Germany.

Andreas Nelle is a partner in Hogan & Hartson's Berlin office.

CORPORATE & FINANCE
REAL ESTATE
TAX
PUBLIC SECTOR
COMMERCIAL

WWW.SIBETH.COM