

CONTROL PREMIUM IN TAKEOVERS? – A NORDIC PERSPECTIVE

Setting the scene

One of the starting points in company law is the *one share one vote* principle, meaning that each share entitles to one vote. However, issuing classes of shares with different voting and financial rights is permitted in many jurisdictions. The Nordic countries have long-established corporate practice of using different classes of shares forming control-oriented corporate governance systems in limited liability companies. Having a ‘blockholder’, a single shareholder or a cohesive alliance of shareholders, who own a major fraction of the voting rights in order to hold a controlling position in the company, has traditionally been quite common in the Nordic countries. At the same time, corporate practice in the UK and the United States have had more of an ‘arms-length’ system of ownership and control due to widely dispersed share ownership, which is common in these jurisdictions. During the past few years, the Nordic control-oriented corporate governance system with wide-ranging use of different classes of shares has been the subject of lively debate. The implications that different classes of shares generate in takeovers has been one of the elementary issues debated.

In the beginning of October 2009, the revised Takeover Rules¹ drafted by the Swedish Industry and Commerce Stock Exchange Committee² and Stockholm Stock Exchange³ came into force in Sweden. The most controversial provision of the revised Swedish Takeover Rules concerns the consideration to be paid for different classes of shares in case of a takeover bid. Swedish Takeover Rules provide that, as a main rule, an equal consideration needs to be offered for each class of shares when offeree company has more than one class of share and these classes deviate from each other only by voting rights. While the Swedish Securities Council⁴ may grant an exemption from this obligation, the preconditions for such exemption are remarkably strict. It is also an interesting point that differing voting rights and dividend rights attached to different classes of shares are not handled similarly in this respect in the Swedish Takeover Rules. While approximately half of Sweden’s 270 listed companies have two or more classes of shares with different voting rights, but similar financial rights, in Finland the corresponding figures are somewhat less significant. However, it is very likely that the revised Swedish Takeover Rules will also have at least some impact on Finnish takeover practices, since the Swedish rules were one of the main sources and examples when the Finnish takeover rules, the Helsinki Takeover Code, were drafted few years ago.

Control premium and price formation

The founding idea behind price formation in modern capital markets can be traced back to the late 18th century and Adam Smith’s concept of the *invisible hand*. By this Smith referred to market mechanism, where the supply and demand of certain merchandise determines its market price. Smith made an assumption of individuals being rational in their decision-making, and suggested that allowing market participants to freely execute their individual preferences through market mechanism automatically leads to the best possible result for the economy as a

¹ Regler rörande offentliga uppköpserbjudanden på aktiemarknaden, (1 oktober 2009).

² Näringslivets Börskommitté.

³ Nasdaq OMX Nordic Exchange Stockholm.

⁴ Aktiemarknadsnämnden.

whole. Today, in the aftermath of the recent global financial crisis, it is quite evident that market participants do not always act rationally, as psychological factors, among others things, played a major role in the emergence of the bubble in the financial markets. Although the recent crisis has cast its doubts on other formerly reigning market theories, e.g. the Efficient Capital Market Hypothesis, it is quite evident that share prices will still in the future be determined by supply and demand, both depending on market participants' subjective valuations.

The bottom line is that stock markets should still be trusted today, unless a better pricing mechanism can be found. A free market is the only device forming a price for shares in a way that enables all investors willing to buy or sell shares to do so according to their subjective preferences. If the price were to be formed in any other way, there would always be the possibility for arbitrage, in one form or another. Therefore, price regulation on modern stock markets has never even been proposed. Yet it should be noted that takeover bids are special events on the stock markets, where the pricing mechanism does not function normally. The rights of the minority shareholders in takeover situations need to be guaranteed by relevant regulation, in order to ensure that they have the required confidence to invest in stock markets in the first place. An example of such regulation is requirement for the takeover offeror to treat all shareholders in the offeree company equivalently. The requirement of equivalent treatment presumes, for example, that the consideration offered is the same in form and amount offered for all securities subject to the bid. However, this doesn't automatically mean that the consideration for different classes of shares should be equal; after all, shares of different classes are two different goods. Therefore, the market values of different classes of shares may differ from each other.

While the Swedish Takeover Rules are based on the view that an equal consideration should be paid for different classes of shares, a more liberal and more ad hoc minded approach is taken, for example, in the *EU Takeover Directive*⁵, in the *City Code on Takeovers and Mergers* and the *Helsinki Takeover Code*. These regulations allow bids for different classes of shares in same offeree company to deviate from each other in respect of the offered consideration. On the other hand, the regulations mentioned above provide that the bids must be reasonable and fair between and in relation to each other, thereby aiming to protect the rights of the all shareholders in the offeree company. Altogether, according to the above regulations, the consideration offered for different classes of shares may differ if the values of different classes of shares. This difference in value may be affected by, for example, voting rights and entitlements to dividends attached to the shares.

The of question whether the consideration for different classes of shares should be allowed to differ in takeover bids is also linked to the freedom of contract principle. In this respect, the rights of the offeror and the offeree are restricted when an equal consideration for different classes of shares is required. In practice, the offeror is typically willing to pay a certain premium for the shares entitling to control in the offeree company, and accordingly, the controlling shareholders of the offeree company require a premium in order to be willing to give up their controlling position. Thus, the rules restricting different considerations for different classes of shares either deny the controlling shareholders from receiving such a premium or give the minority shareholders the same premium required by the controlling shareholder. Another side of the story is that the rules restricting different considerations for different classes of shares prevent paying premiums for control exclusively to the controlling shareholders. This leads either to higher overall costs for the offeror, or to an offer that doesn't provide compensation in full to the controlling shareholders for their lost controlling position in the offeree company. Both options significantly increase the risk that the takeover will not be fulfilled, or even launched in the first place. This may create a trend deterring overall takeover activity that could have significant effects on the functioning of the capital markets.

⁵ Directive 2004/25/EC of the European parliament and of the council of 21 April 2004 on takeover bids.

Another question is why do stock markets reflect rumours of potential takeovers in the rumored offeree company's share price? Most likely this is due to *normal takeover premium*. By normal takeover premium, I refer to the market practice in takeovers that the offeror offers a certain premium to the offeree company's current share price in order to make the bid more tempting to the shareholders of the offeree company. Market participants consider that a potential takeover bid would include certain premium in order to be successful, and therefore, the offeree company's share price tends to rise. The increase in share price is usually in proportion to the anticipated normal takeover premium. Naturally the market price of a share is in reality subject to a more thorough assessment, and in some occasions, the reaction of the market price may well be the opposite, especially if the potential takeover bid is seen as negative for the offeree company for one reason or another. Nevertheless, it is probable that the premium paid for controlling shares (control premium) does not play any noteworthy role in price reactions for rumored takeovers in modern capital markets.

In this context, the difference between a normal takeover premium, as discussed above and premium paid for controlling shares (control premium) requires a more in-depth review. By *control premium*, I refer to a premium that needs to be offered to the controlling shareholders in order to make them willing to give up their controlling position in the offeree company. While the paid normal takeover premiums are somewhat consistent in relation to each other, control premiums vary greatly case by case. This is due to the fact that the magnitude of the control premium depends on how the offeror and the controlling shareholders (subjectively) value the control in the offeree company. A control premium is typically required by the controlling shareholders regardless of how the controlling position is gained in the first place. The controlling position may be simply based on owning majority of shares, but it may also be based on multiple voting shares, shareholders agreements, cross shareholdings, etc.

The issue of control premiums has implications reaching far beyond takeovers. Control premiums are frequently under debate in the Nordic countries when different classes of shares are combined. Often the controlling shareholders demand equitable compensation for losing their multiple voting rights. For example, there are cases in Finnish corporate practice where, in conjunction with the combination of share classes, the voting rights lost by the holders of shares with multiple voting rights have been compensated for, e.g. by a directed share issue without payment, but there are also cases where no compensation has been paid. The main reasoning for not compensating the controlling shareholders for the voting rights they lose has been the fact that the market prices of different classes of shares often tend to be somewhat equal in day-to-day trading when a company's different share classes are subject to public trading. Doesn't this build a strong case for the presumption of equal market values for different classes of shares?

Not necessarily, since the controlling share blocks are typically not for sale in day-to-day trading, at least when a listed company has a share class with multiple voting rights. Instead it is very common that controlling share blocks are traded outside of the regular trading system of stock exchanges or even outside of stock exchanges entirely. The transaction price can be exclusively determined by the buyer and the seller, without causing an immediate impact and potentially artificial effect on the share price, which might happen if the shares were traded through a continuous trading system on a stock exchange. Furthermore, when controlling blocks are traded, the buyer typically also pays a control premium to the seller in addition to the price the share has on the stock exchange. When market participants presume that the control of a company is not for sale in day-to-day trading, there is no reason why they would quote bids including a control premium. Accordingly, this is the main reason why control premiums are not typically reflected in share prices in day-to-day trading. Another reason why control premiums are not reflected in share prices in day-to-day trading is that voting rights may only be used in shareholders' meetings and market participants are well aware of up-coming shareholders' meet-

ings. Thus, it is only rational not to include a control premium in the day-to-day trading price, if there are no shareholders' meetings in near future.

A somewhat similar phenomenon is usually seen with dividends. Since dividends are normally paid only once a year, most of the year stock markets do not reflect the prospective dividend in the share price. However, as the record date for the payment of dividends gets closer, the price of the share tends to rise in proportion to the prospective dividend, and on the day after the record date, the share price decreases in proportion to the dividend. It is therefore quite interesting that the Swedish Takeover Rules provide that, if the different classes of shares deviate from each other as to financial rights, considerations offered shall not be unreasonable between and in relation to each other. The considerations to be paid for different classes of shares in a takeover bid do not need to equal when different classes of shares deviate from each other by financial rights. Differing voting rights and financial rights attached to different classes of shares are not handled similarly in this respect in the Swedish Takeover Rules. While the actual reason behind this might be that the pecuniary value of financial rights is more transparent and easier to assess, it still does not satisfactorily explain the explicit predefinition between compensations for voting rights and financial rights.

There are many cases in Nordic takeover practice where the voting rights lost by the holders of shares with multiple voting rights have been compensated. However, traditionally, there have also been cases where no compensation has been paid for the lost controlling position. Thus, it is quite obvious that no straightforward conclusions can be drawn from Nordic takeover practice. Further research is also needed to determine whether control premiums were one of the original factors creating the current market practice among takeovers of paying a normal takeover premium. This may well be a fact, and to some extent it might also affect on the issue of whether control premiums should be allowed in the current takeover practice. However, this question is not further considered in this article. Altogether, making well-grounded conclusions regarding whether subjective valuations for the controlling position, in form of a control premium, should be allowed in takeover practice requires more thorough and detailed review.

Voluntary bids and mandatory bids

In practice, takeover bids are launched either by a voluntary bid or a mandatory bid⁶. A voluntary bid is at hand when the bid is launched without any legal obligation to do so. A voluntary bid may be launched either for a fraction of the shares of the offeree company or for all of the shares. A mandatory bid on the other hand is launched when the offeror has acquired a certain number of voting rights carried by the shares in the offeree company. A typical threshold for a mandatory bid defined in legislation is 30 per cent and/or to 50 per cent of the voting rights carried by the shares in the offeree company, and mandatory bids must be made for all the remaining shares in the offeree company. Due to the slightly differing features of a voluntary bid and a mandatory bid, the possible consequences of restricting the payment of a control premium in connection with the consideration offered for different classes of shares among voluntary bids and mandatory bids need to be reviewed in more detail.

One of the key elements to be assessed in both voluntary bids and mandatory bids is the current share ownership structure of the offeree company. The more dispersed and unstable the share ownership structure is prior to a bid, the less significance should be given to the controlling position or paying compensation for losing such a position. However, it has traditionally been com-

⁶ Takeover bids may also be launched by squeeze-out and sell-out, but these special cases are not further considered in this article, since squeeze-outs and sell-outs are quite similar to mandatory bids in respect of control premiums.

mon in Nordic corporate practice to have a shareholder in a controlling position in the company. In such a case, the controlling shareholders typically require a premium in order to be willing to give up their controlling position. This is because the controlling shareholder has some subjective and shareholder-specific reason for the controlling position, such as synergies for the controlling shareholder's related businesses or industry-specific business knowledge related to the offeree company. Both of these examples of *private benefits of control* are shareholder-specific and may not be realised simply by looking at the market price of a share.

Traditionally, private benefits of control are considered to be negative in capital markets, since they tend to deter the functioning of the market for corporate control. Markets for corporate control are based on the idea that, if the current management appointed by the controlling shareholders fails to run the business efficiently, the market price of the shares will fall, thereby increasing the risk of takeovers and the management be replaced. Well-functioning markets for corporate control, therefore, enhance the overall efficiency of capital markets. In addition, private benefits of control are considered to be negative, because they have been seen to increase the risk that controlling shareholders will exploit their position at the cost of minority shareholders. These are typical negative examples of private benefits of control.

Nevertheless, it should be noted that all shareholders of the company may also benefit from the existence of certain shareholder specific benefits (e.g. industry-specific business knowledge) through higher returns on their investments if the controlling shareholder is able to make the business more profitable overall. However, while the minority shareholders are able to limit their firm-specific risk by having a diversified investment portfolio, the controlling shareholder carries the firm-specific risk of investing its industry-specific business knowledge into the offeree company. A required control premium may, therefore, be considered as compensation required by the controlling shareholder for giving up prospective benefits from its industry-specific business knowledge. Based on the above, private benefits of control may be either negative or positive, which underlines need for a case-by-case evaluation of whether they should be compensated in takeover bids.

This has another indication as well, since when the offeree company has a controlling shareholder, the opinion on the bid is often inquired from the controlling shareholder before the bid is launched. If the offeree company has one or a few major shareholders who could prevent the completion of the bid, entering into discussions with such shareholders prior to the bid may be reasonable in order to prevent harmful effects caused by a failed takeover bid. Such harmful effects are mainly transaction costs and negative publicity. A categorical restriction of paying control premiums would significantly affect the negotiations between the offeror and the controlling shareholders on the consideration to be paid. While the controlling shareholders typically demand equitable compensation for giving up their controlling position, the offeror in turn has a certain overall cap for the consideration to be paid in a takeover bid. A categorical restriction of paying a control premium for multiple voting shares would therefore narrow the effective margin in the pricing of the bid, especially in cases where the controlling shareholder has positive private benefits of control in the offeree company. This in turn might deter overall takeover activity, at least among companies with different classes of shares.

Coming back to voluntary bids and mandatory bids, the current share ownership structure of the offeree company should be taken into account when deciding what the rightful consideration for different classes of shares would be in a takeover bid. Voluntary bids may also be launched for a fraction of the shares, and it is possible to launch a bid for a fraction of shares that will not produce a controlling position in the offeree company. In such a case, it is evident that an equal consideration should be offered for different classes of shares. However, in cases where a mandatory bid is launched or a voluntary bid is launched for all of the shares of the offeree company, the assessment is somewhat different. If the offeree company has a controlling shareholder other

than the offeror, whether or not the controlling shareholder has any positive private benefits of control in the offeree company is something that should be assessed. Traditionally this evaluation and the effects thereof on the pricing of the prospective bid have been decided between the offeror and the controlling shareholder. On other hand, if the offeree company does not have a controlling shareholder holding any positive private benefits of control or does not have a controlling shareholder at all, most likely there are no incentives or reasons for the offeror to pay a control premium. In such cases the offeror would probably launch a bid providing a normal takeover premium in order to make the bid more tempting to all shareholders of the offeree company and thereby enhancing the possibilities for the bid to be successful.

It should be noted that a shareholder may have a controlling position in a company while having acquired a fraction smaller than 30 per cent of voting rights carried by the shares in the offeree company if the offeree company has a widely dispersed ownership structure. Typically, the threshold for a mandatory bid is defined in legislation as 30 per cent and/or as 50 per cent of the voting rights carried by the shares in the offeree company. Although a fraction smaller than 30 per cent of voting rights may create an actual controlling position in companies with a dispersed structure of share ownership, the threshold set in legislation provides a practical and effective basis for the assessment of whether a shareholder has a controlling position. However, further research in a broader context should be carried out on this issue.

Conclusions

The main reasoning for regulating takeovers in general is the protection of minority shareholders. The rights of the minority shareholders in takeover practice need to be guaranteed by relevant regulation in order to ensure that they have the required confidence to invest in stock markets. Equivalent treatment is a universally accepted principle in takeover practice that should always be followed throughout the takeover process. One of the issues upon which equivalent treatment is assessed is the consideration offered for different classes of shares in a takeover bid. The EU Takeover Directive, the City Code on Takeovers and Mergers and the Helsinki Takeover Code allow bids for different classes of shares in the offeree company to deviate from each other in respect of the offered consideration. However, the abovementioned regulations provide that the bids must be reasonable and fair between and in relation to each other, thereby aiming to protect the rights of minority shareholders. The Swedish Takeover Rules, on the other hand, are strongly based on a view that an equal consideration should be paid for different classes of shares when classes deviate from each other only by voting rights.

There are many aspects that typically need to be assessed when deciding reasonable and fair consideration(s) for different classes of shares in a takeover bid. First, the market prices and liquidity of the shares of different classes need to be examined. Secondly, the opinions of the offeror and the offeree on the rightful consideration should be taken into account, since both the market mechanism and the freedom of contract principle would imply that the pricing of the prospective bid should be decided between the offeror and the offeree. Thirdly, the current structure of share ownership in the offeree company and the potential existence of a controlling shareholder with positive private benefits of control in the offeree company should be considered when assessing reasonable and fair consideration(s) for different classes of shares. In addition to these company-specific issues, what kind of a role the relationship between the normal takeover premium and control premium have in the case in question should be assessed. The EU Takeover Directive, the City Code on Takeovers and Mergers and the Helsinki Takeover Code allow a case-by-case evaluation of these and other case-specific issues, and a statement from national takeover panels may also be applied to the consideration for different classes of shares in a take-

over bid. In practice, these regulations have worked well, providing the required flexibility in connection with the wide variety of case-specific features characteristic of takeover practice.

It is clear that, in Sweden, an equal consideration will be offered in vast majority of takeover bids for companies that have more than one class of share due to the new takeover regime. Since only in certain strict circumstances has the Swedish Securities Council the right to grant permission for different forms of consideration to be paid, there is little room for exemptions. This will have strong effects on Swedish takeover practices, but possibly also on the future development of Nordic takeover practices. Therefore, the implications that this controversial provision of the revised Swedish Takeover Rules may create should be closely examined before introducing such provisions in other jurisdictions, for example in Finland.

The main reasoning for the controversial provision of the revised Swedish Takeover Rules has been stated to be that different classes of shares with multiple voting rights and the takeover practices related to them are unfamiliar to international investors. Therefore, they may be reluctant to invest in the shares of Swedish companies, which also deter takeover activity in Sweden. This is an interesting point of view, since the proportion of foreign ownership in the Nordic capital markets has been relatively high for a long time. It could be asked, whether the true aim of the provision is to undermine the status of different classes of shares in Swedish corporate governance. If that is the case, it should be handled in relevant company legislation, rather than in takeover rules. This is required by legal redress. However, abolishing multiple voting shares, in turn, might lead to extensive use of less transparent mechanisms in corporate governance, such as shareholders' agreements, proxy voting and derivatives. Such mechanisms are somewhat familiar in jurisdictions where share ownership structures are typically more dispersed, namely in the UK and the United States.

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