Issues to consider when structuring a cross-border merger under the Cross-Border Merger Regulations

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Ben Simpson
SPECIAL COUNSEL | UK

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Overview

A stream of UK companies are merging with other EEA companies by way of cross-border merger. It is unclear whether this is being driven by Brexit. In the meantime, a trickle of cross-border mergers into UK companies continues to be implemented. In addition, the recent determination by the Court of Appeal that a merger involving a dormant Dutch company was not an abuse of process should encourage more groups to consider cross-border mergers. The Court of Appeal decision may also allow UK groups to engineer a cross-border merger by setting up an EEA company in advance of any proposed merger. This will often be more attractive than other alternatives such as the liquidation route under section 110 Insolvency Act 1986.

Merger by absorption


The Regulations allow three different types of cross-border mergers:

- a merger by absorption (an existing company absorbs one or more other merging companies);
- a merger by absorption of a wholly-owned subsidiary (an upstream merger); or
- a merger by formation of a new company (two or more transferor companies, at least two of which are governed by the laws of a different EEA state, merge to form a new company).

Reverse cross-border mergers

Reverse cross-border mergers where a parent company merges into its subsidiary are becoming increasingly common and are effected by way of a merger by absorption. A merger by absorption pursuant to the Regulations occurs when:

- there are one or more transferor companies, an existing transferee company and at least one of these companies is a UK company and one is an EEA company;
- every transferor company is dissolved without going into liquidation and on dissolution transfers all its assets and liabilities to the transferee company; and
- the consideration for the transfer is shares or other securities representing the capital of the transferee company and, if so agreed, a cash payment recoverable by the members of the transferor company.

A number of company law issues need to be addressed where the transferee company is a UK subsidiary such as how to deal with the parent company’s share in its subsidiary.

A recent example of a transfer by a UK company into an EEA subsidiary was the Fomenta Ltd merger where Fomenta Ltd was absorbed into its Italian subsidiary, Immobiliare.
The process for implementing a merger is as follows:

- each company circulates a merger proposal, management report and, if required, an independent expert’s report to its shareholders. Whilst the UK rules may allow an independent expert’s report to be dispensed with and to not require any other reports to be produced in connection with a cross-border merger, other jurisdictions may still require an expert to provide an opinion that shares being issued pursuant to the merger are not being issued at a discount (in accordance with the requirements of the relevant jurisdiction’s ‘Companies Act’). Whilst the directors of an English company need to ascertain that shares issued by a UK transferee company pursuant to a merger are not being issued at a discount to their nominal value, there is no requirement for an English private company to obtain an independent expert’s report to that effect;
- the shareholders of the UK merging company approve the merger (unless the requirement for a shareholder meeting is waived), and the creditors approve the merger where a creditors’ meeting is ordered by the Court;
- the competent authorities in the merging companies’ jurisdiction (the High Court in England and often a notary in other EEA jurisdictions) certify completion of the pre-merger requirements. If there is no need for the UK merging company to have a shareholders’ meeting (a ‘general meeting’) and no merging company has any employees, it may be possible to seek certification in the UK within one to two months from the date of publication of the draft terms of merger and form CB01 (the ‘Delivery Date’). If any merging company has employees, the pre-merger certificate cannot be obtained until more than two months after the Delivery Date. The Regulations set out the timetable for a merger by reference to the date of the general meeting to approve the merger. Where a general meeting is not required or where the requirement to hold it has been waived the High Court has indicated that the timetable set out in the Regulations should be read to require the Court to be satisfied that “at least two months before the hearing at which the pre-merger certificate is to be sought the relevant documents have been with the Registrar of Companies and advertised by him, and that for at least one month employees and creditors have had the opportunity to consider those documents”;
- the merger is approved by the competent authority of the country where the merged entity will be registered. In England, this will be the High Court. Application for final approval must be made within six months of obtaining pre-merger approval. If it is granted, the court will fix a date on which the consequences of the cross-border merger are to take effect. This date must be not less than 21 days after the order is made (but can be at any earlier date selected by the merging companies which will often be a financial year end); and
- the merging company is required to register the merger documents with the Registrar of Companies who must, where relevant, strike off the UK transferor company and notify the registrar in the jurisdictions where the other merging EEA companies are registered.

Timing

For a company either with no employees or with employees who have no right to participate in management, the full process of a cross-border merger is likely to take around four to six months. If the employees of the merging companies have a right to participate in management, a merger will take longer, as employee participation rights may take up to 12 months to agree.

Employee participation

The Regulations state that cross-border merger operations must take into account employee participation rights, where they exist. They do not impose any new participation requirements, but seek to ensure that when these are already in place prior to the merger, they are retained by the merged entity. Consequently, the competent authority may only give final approval for a merger once such arrangements have been agreed in accordance with the Regulations.

Unlike some EEA countries (such as Germany, Austria, the Netherlands or Sweden), the UK does not have a statutory right to employee participation. However, if any voluntary arrangements are equivalent to employee participation rights (which would be unusual in the UK), these must be retained post-merger.

The employee participation provisions apply to a UK transferee if any merging company has employee representatives amongst members of the administrative or supervisory organ (in the UK, the Board of Directors) or its committees or the management group, which covers the profit units of the company. The rules also apply if a merging company has, in the six months before the publication of the draft terms of merger an average number of employees that exceeds 500 and has a system of employee participation or if a UK Merging Company has a proportion of employee representatives amongst the directors. Mergers involving UK companies which trigger the employee participation provisions are rare; one example was the Sony DADC UK Limited merger with Sony DADC Austria GmbH.

Issues to consider when structuring a cross-border merger

Waiver

The shareholders in the transferor company are entitled to waive their right to receive shares or other securities in the transferee and this was confirmed in the High Court decision of Olympus UK Limited and others [2014] EWHC 1350. The High Court determined that all was required was that, in the case of a merger by absorption, the right of members of the transferor company to be offered shares in exchange should be recognised, even if those rights are simultaneously declined by all members.

Genuine merger

The Court of Appeal has determined in Easynet Global Services Limited (Appellant) and Secretary of State for Business, Energy & Industrial Strategy [Intervener] [2018] EWCA Civ 10 that the Directive (which has been re-enacted in Directive EU 2017/1132) should bear its ordinary meaning and that no limitation should be applied on the ability of UK companies to merge with other EEA compass pursuant to the Regulations by virtue of the scale or dormancy of a particular company. The Court of Appeal rejected the proposition that a company might need to be sufficiently capitalised or trading at a significant level to be able to participate in a cross border merger.

The Court of Appeal also determined that, absent fraud, it would be difficult to identify when companies exercising their rights under the Directive would be seen to be an abuse of process. It was also noted that the Secretary of State for Business, Energy & Industrial Strategy who made submissions to the Court of Appeal did not contend that there was any public interest in compelling UK companies to use the alternative routes for
An increasing number of mergers are being effected by reverse cross-border merger. In the case of a merger by absorption into a UK subsidiary, the shareholders of the transferee company will become the shareholders of the transferor company, as well as the rights and obligations arising from employment contracts with the transferor companies; (b.) the transferor companies are dissolved; (c.) where one or more of the merging companies does not fall within the prescribed type of companies e.g. a Dutch cooperative is not a prescribed type of company; or (d) where the proposed merger is between two or more UK companies.

When are you unable to effect a cross-border merger?
The cross-border merger procedure may not be used: (a.) where one or more of the merging companies is to be wound-up; (b.) where the consideration for the merger does not take the form of shares or securities in the transferee (and, if agreed, cash) or if the consideration is not waived; (c.) where one or more of the merging companies does not fall within the prescribed type of companies e.g. a Dutch cooperative is not a prescribed type of company; or (d) where the proposed merger is between two or more UK companies.

Effective date of a merger
The parties are free to choose an effective date for the merger which will customarily be the end of a financial reporting period for one of the merging companies.

Share rights
If a person holds (other than as a creditor or shareholder) any securities of a UK transferor company (other than shares) which have special rights attached to them, the draft terms of merger need to make provision for the person to obtain rights in the transferee company of equivalent value. The holder of the securities may however, agree otherwise or require the transferee company to purchase the securities on terms that the High Court considers are reasonable.

Transfer of assets by the transferee company
The consequences of a cross-border merger are: (a.) the assets and liabilities of a transferor company are transferred to the transferee company as well as the rights and obligations arising from employment contracts with the transferor companies; (b.) the transferor companies are dissolved; (c.) in the case of a merger by absorption or a merger by formation of a new company, the shareholders of the transferor company become shareholders of the transferee company.

Impact of Brexit
If the transferee company is a non-UK company, it may be prudent to ensure that the merger by absorption completes prior to Brexit until such time as the implications of Brexit for cross-border mergers are clarified. However, it is anticipated that UK companies may still be able to merge with EEA companies under the regulations after Brexit if the laws of the relevant EEA country permit cross-border mergers with a non-EEA company.

Reverse cross-border merger into a UK subsidiary
An increasing number of mergers are being effected by reverse cross-border merger. In the case of a merger by absorption into a UK subsidiary, the...
completion of the merger will result in the UK company acquiring its own shares which were previously held by its parent.

**Share Cancellation**

A cancellation of shares may be effected by way of a reduction of capital or, if the consideration for the shares in the UK company being acquired is waived, the transfer of shares may be treated as a gift which would then allow the UK company to cancel the shares gifted to it. If the UK company is a wholly owned subsidiary this would need to be effected by way of a court approved reduction of capital because, as a result, there would no longer be any member of the UK company holding shares. If there were two or more members, it would be possible to effect a reduction of capital by way of a special resolution supported by a directors’ solvency statement. A reduction in capital takes effect when the court order or solvency statement together with a statement of capital are registered at Companies House.

**Buyback**

A buyback of shares would be effected by way of a buyback agreement and a written resolution. This will not be possible in the case of a wholly owned subsidiary, as the shareholder holding the shares will not be eligible to vote. One way round this would be to transfer one share to a nominee of the parent company in advance of the merger.

**Waiver**

In accordance with the High Court’s decision in the Olympus case, the parent company may waive its entitlement to consideration as regards the value of the shares in the UK company being transferred. A waiver of consideration by the parent company would avoid any argument that the acquisition of shares pursuant to the Merger is an unlawful acquisition and accordingly void pursuant to s658 Companies Act 2006 (assuming it cannot be argued that the fact that the acquisition occurs by operation of law means there is no acquisition for consideration). The transfer of the shares in the UK company may then be treated as a gift which would enable the UK company to cancel the shares transferred.

**Transfer to the member of the transferor**

An alternative method of structuring a downstream merger would be for the shares in the UK company to be transferred to the member of the transferor company on completion of the merger. In the merger of Rössle Kaufland Supermarktions GmbH (the ‘RM Merger’), shares in the German subsidiary were transferred to the shareholder in the UK transferor company and a similar approach has been taken in downstream mergers in other jurisdictions. The transferee company was a German company and therefore German law applied as regards the transfer of the shares in the German company to the shareholder of its UK parent company.

The Regulations envisage that the consideration for a transfer effected by merger will be ‘shares or other securities representing the capital of the transferee company and, if so agreed, a cash payment receivable by a member of the transferor company’. The English version of the Directive, refers to the ‘issue’ of shares in consideration. In the Olympus case, the Judge stated that: “[...] the flexibility in terms of what is required to be made available to the shareholders of the transferor(s), which appears to be offered by the German and French versions of the Directive, suffices to justify, in my view, taking as the autonomous meaning of the word ‘issue’ a less precise and restrictive meaning extending to grant, allocation or allotment, without also stipulating receipt and registration.”

He went on to say: “It would not be right to read the definition of cross-border merger in the Directive as requiring an ‘issue of shares’ in the strict sense of that word in English company law; and that all that is required is that the rights of members of the transferor company, in the case of a merger by absorption, to be offered shares in exchange should be recognised, even if those rights are simultaneously declined by all the members.”

A point not determined in the Olympus case is whether the reference in the Directive to the ‘grant’ of shares and ‘to be offered shares in exchange’ covers the transfer by the UK merging company of the parent’s shares to the UK merging company’s shareholders in the case of a downstream merger by absorption. However, the fact that this approach has been taken in Germany, in the RM Merger, and in Italy might suggest that an issue of securities or shares should include such a transfer of shares by the UK merging company.

**Limited Liability Partnerships**

A separate decision in relation to limited liability partnerships, in the matter of Lanber Properties LLP v Lanber II GmbH [2014] EWHC 4713, has confirmed that where a member of the transferor LLP is already a member of the transferee LLP, the requirements of the Regulations may still be satisfied notwithstanding that these members do not become members of the LLP given that they are already members. In the Lanber merger, the existing members were credited with having made an additional contribution to the capital of the LLP and no other cash consideration was paid to these members.

**Tax considerations for a merger into a UK company**

In the case of a merger by absorption where the transferor company is an EEA entity and the transferee is a UK company ("UKCO") then the effect of the merger will be that the assets and liabilities of the EEA company will be treated as transferring by operation of law to UKCO following completion of which transfer the EEA company will cease to exist as a separate legal entity without going into liquidation.

There should be no disposal of any capital assets recognised in the jurisdiction of the EEA company and any capital assets that it owned will continue after the merger in the ownership of UKCO. A significant point to note here is that UKCO will be treated as taking over any capital assets held by the EEA company and, notionally, will be considered to have acquired such assets at the time they were acquired by that EEA company and for the consideration paid by the EEA company at that time. There is no provision in UK tax law (whether pursuant to European law or otherwise) which allows for an uplift in the value of any capital assets to their value at the date of the merger. In some mergers this may be a significant issue especially when substantial real estate assets pass from an EEA transferor to UKCO through a merger by absorption (although in some situations this might possibly enhance a company’s ability to make use of historic losses for purposes of claiming UK tax relief).

Going forward UKCO would, broadly, be subject to UK corporation tax at the prevailing rate (currently 19%) on its worldwide profits and gains (whether remitted to the UK or not) based on its pre-existing activities and assets as well as in respect of any activities/assets acquired from the EEA company pursuant to the merger. If, post-merger, UKCO carried on any activity in the EEA country where the EEA company had been established then this could give rise to a permanent establishment in that country any profits of which would potentially be subject to tax in that country.

Since such profits would also be taxable under UK law it would be necessary to consider whether it was either possible or desirable to make a
branch profits election in order to negate an overlapping UK tax charge. Such an election is subject to various conditions and so it would not always be either possible or desirable to proceed in such a manner. UK tax law (either by treaty or under internal provisions) usually makes provision for a UK tax charge to be reduced by the amount of any foreign tax charged on foreign branch profits, although a credit mechanism of this kind is also subject to various conditions and restrictions (for example, as regards the timing of claims, the extent of the credit and the utilisation of any surplus or excess credit against any past or future profits that would otherwise be subject to possible double taxation).

No UK stamp duty or stamp duty reserve tax charges should arise as result of a merger into UKCo as there is neither a transfer of shares in a UK company nor the transfer of any interest in such. The VAT position in the UK (and possibly also in other countries affected by the merger process) would need to be considered, although it will often be the case that a merger of this kind is either a non-event for VAT purposes or an untaxed “transfer of a going concern.”

The tax position in relation to transfers of UK real estate might sometimes need careful consideration. This is especially so if any affected land or buildings are located in Scotland or Wales, since the former UK-wide charge to stamp duty land tax (SDLT) on transfers of any UK real estate has been replaced by a devolved tax in Scotland with effect from April 2015 and a similar devolution will take effect in Wales from April 2018. The Scottish and Welsh property transfer tax regimes are similar to the SDLT regime but not completely identical, and they are administered by separate governmental bodies which may form their own official views and practices. It is arguable that a merger by absorption is outside the scope of SDLT (and/or similar taxes) but the matter is untested. In some (but not all) merger situations a formal claim for group relief would potentially put the matter beyond doubt.

The foregoing comments about UK stamp taxes, property taxes and VAT would also generally be relevant when considering an alternative form of cross-border merger scenario in which UKCo acts as the effective transferor rather, than the transferee, of a business activity or its assets. However, different considerations might well arise when considering the corporation tax position of UKCo in such a situation.

Applying general principles of traditional UK tax law, a merger process would often involve a disposal of assets by one company in favour of another (and some such disposals might now be treated as generating income, rather than capital, for UK tax purposes because the traditional distinction between income and capital has effectively now been abolished in certain areas of the UK’s corporation tax code). Some disposals of this kind might be eligible for relief or exemption under traditional principles of UK law (for example, transfers between companies within the same group where both parties are chargeable to UK tax on the same basis) but disposals of assets are not universally protected from taxation in an ordinary business reorganisation context, even where the parties are closely related.

Therefore, UK tax law contains certain special additional rules that are designed to protect approved EU cross-border mergers from immediate exposure to UK taxation in respect of possible asset disposals or business transfers that take place as part of the relevant merger process. However, it is important to note that the UK’s domestic implementation of European merger principles only operates in such a way as to protect the merger process itself from exposure to UK taxation. An attempt to withdraw a business activity, or the assets previously used in such an activity, from the UK will not necessarily be immune from UK taxation just because the withdrawal is associated with a cross-border merger process.

Court scrutiny

One of the advantages of pursuing a cross-border merger pursuant to the Regulations is that, unlike most other forms of merger under English law, the effect of a cross-border merger pursuant to the Regulations is to transfer all contractual rights and obligations to the transferee company, even if such contracts would not otherwise be assignable. As a result, a merger pursuant to the Regulations may be an attractive method to reorganise a corporate group.

As mentioned above, in the case of a UK merging company, which is a transferee company, the High Court will scrutinise various aspects of the merger and make an order fixing the date on which the cross-border merger is to have effect which must be not less than 21 days after the date on which the order is made. The level of scrutiny required by the UK court was questioned in Re Livanova Plc and Sorin SpA [2015] BCC 915. In the Livanova case it was suggested that the court’s role was to undertake a narrower assessment of whether or not the requirements of Regulation 16 of the Regulations had been satisfied. In the earlier case of Re Diamond Resorts (Europe) Limited [2013] BCC 275, it was suggested that the court should carry out a wider scrutiny of the proposed merger with a view to being satisfied that it did not adversely affect any stakeholder (whether shareholder, employee or creditor) in any of the merging companies in any material way and that there was no other good reason why approval of the proposed merger should be refused. It was suggested that if the competent authority in the jurisdiction of another merging company had not carried out any investigation of the merits of the transaction, it was then the duty of the English court to consider the merits of the merger from the perspective of the shareholders, creditors or employees of the overseas merging company.

It is this greater degree of scrutiny than the process expressly set out in Regulation 16 that was queried in the Livanova decision. The High Court gave the matter further consideration in M2 Property Invest Limited and Vendor Wind Service SP Z.O.O. (‘M2 Property’) and the Judge indicated that he preferred the argument that “the English court should not, at the stage of approval hearing, concern itself with the interests of creditors of either company, because it is for the domestic laws of each merging company to protect the interests of the respective creditors of those companies at the pre-merger stage.” However, the Judge in M2 Property did not need to make a final determination on the point. The Judge did, however, comment that “the structure of the Directive appears to be that it is for the national laws of each of the respective merging companies to implement appropriate protection for the creditors of their own company, so that by the time that the matter reaches the second stage, the court should be entitled to rely upon the pre-merger certificates and assume that the correct procedures have been followed. This will mean that creditors will have been given the opportunity to avail themselves of whatever measures for creditor protection exist under national law.”

Until the position has been determined in the English courts, it would be prudent to ensure that evidence is available of the benefits of the proposed merger for the shareholders, creditors and employees of the merging companies concerned. This evidence should be expressly set out in the merger documentation and up to date financial information on both merging companies should be adduced for the pre-merger certificate hearing.

Conclusion

In conclusion, cross-border mergers are proving to be a helpful mechanism to transfer business operations across EEA borders. Whilst the requirement for court hearings and the prescriptive nature of the Regulations makes the process administratively burdensome, a cross-border
merger is, in practice, relatively straightforward to implement and, where employee consultation is not required, may be implemented relatively quickly.