Creditor Protection in the Market for Corporate Control

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1. Abstract

The market for corporate control is assigned the important *corporate governance* role of addressing the conflicts of interest between the company constituencies, by rendering directors and managers accountable to shareholders and pursuing efficiency goals. As a result of the acceptance of hostile takeovers in European jurisdictions, Directive 2004/25/EC[1] established a board neutrality rule that restricts the powers granted to board of directors[2] when facing a takeover attempt- and, consequently, its ability to determine the outcome of the bid. The Portuguese legislator *opted-in* this rule, thus not granting the board much discretion to adopt defensive measures[3]: its main influence on the acceptance or rejection of the bid is exercised through a report on the conditions and opportunity of the offer[4].

The allocation of the decision on the success of the takeover to the shareholders leaves, however, some unsolved problems, as the exclusive consideration of shareholder interests may lead to the adoption of riskier strategies, to the detriment of other constituencies. Creditors can be affected by a takeover: as a result of such control transaction, the newly-owned company's share value can drop, diminishing its asset base and rendering creditors' claims and bonds less valuable. Additionally, creditors can stand to lose out on changes in the company's strategy (especially in the company's risk profile) implemented by the acquirer, which is why they may be interested in deterring the takeover.

The problem to which the present study is addressed is whether there is room for the consideration of creditor interests in the event of a takeover that can render directors accountable towards them. Moreover, we will provide some contractual remedies which might help some creditors mitigate the effects of an unwanted takeover.

1- EU Directive 2004/25/EC of the European Parliament and the Council of 21 April 2004 on Takeover Bids (hereinafter "Directive" or "Takeover Bids Directive").

2- In art. 278º of the Portuguese *Code of Commercial Companies* of 1986 (hereinafter quoted as "CSC") three alternative models of managing and auditing stock corporations are provided: a one-tier system, which only comprises a board of management ("*Conselho de Administração*"); the traditional two-tier system (arts. 390º and ff. CSC), with a board of management ("*Conselho de Administração*") and a board of auditing ("*Conselho Fiscal*"); and a three-tier system (arts. 424º and ff. CSC), with a board of directors ("*Conselho de Adminstração Executivo*"), a supervisory board ("*Conselho Geral e de Supervisão*") and a statutory auditor ("*Revisor Oficial de Contas*"). *See* ANTUNES, J., "An Economic Analysis of Portuguese Corporation Law- System and Current Developments", 2009, 35-38 (http://www.estig.ipbeja.pt/~ac_direito/antunes.pdf,). The obligation of neutrality bounds the members of the board of management, in the one-tier and two-tier systems, and the members of the board of directors and of the supervisory board in the three-tier system. During this study, we shall use the expressions "board of directors", "board" and "management" to refer to either of those managing bodies, as our topic of research does not require a distinction between the three different systems.

3- *See* art. 182º of the Portuguese *Code of the Securities Market* of 1994 (hereinafter quoted as "CVM").

4- *See* art. 181º CVM.

2. Takeovers and the Market for Corporate Control as Corporate Governance Mechanisms

To properly assess the effects of takeovers in the position of corporate creditors, it is important to consider that hostile takeovers are considered "*the most dramatic of all the corporate governance devices*"[5], and are crucial to mitigate conflicts of interest emerging between the diverse constituencies of publicly held corporations[6]. Relevant literature assigns the market for corporate control a *corporate governance disciplining function* as well as an *efficiency function*[7]. Such roles have different consequences according to companies' ownership structures.

Firstly, it is considered to be a key mechanism to render directors and managers accountable to shareholders, as takeovers can be executed with the purpose of removing an underperforming board. If the company's shares are being traded below the fair value of the same assets[8], it may become an acquisition target[9]; potential buyers will target poorly a performing firm and make an attempt to acquire the company, replacing the current board by another which will enhance its performance. Additionally, if directors and managers have reasons to suspect that a hostile bidder[10]might take control if they run the company badly, such threat will *ex ante* induce them to minimize the costs and inefficiencies in order to maximize the company's value. In the *market-oriented* takeover regulation, adopted in the U.K. and the U.S systems of corporate governance[11], takeover regulation is centred on this idea[12].

The disciplining effect of takeovers is basically a remedy against shareholder apathy, which is why in Continental Europe, where more concentrated ownership structures prevail[13], takeovers serve mainly efficiency goals- when the potential acquirer seeks to exploit synergies by combining the target company's assets with the ones from another firm. The primary goal of takeover regulation in such jurisdictions is the protection of minority shareholders (by the prevision of exit rights[14] and of a sharing rule for the control premium[15]) and of stakeholders

5- ARMOUR, J. and. SKEEL, D., "Who Writes the Rules for Hostile Takeovers and Why? – The Peculiar Divergence of U.S. and U.K. Takeover Regulation", 2007, University of Pennsylvania Law School, 1733, (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1523307).

6- According to art. 13º CVM, publicly held or open corporations ("*sociedades abertas*"), as opposed to privately held corporations ("*sociedades fechadas*") are defined in general as stock corporations whose equity capital is open to public investment. They are ruled by the CSC rules applicable to stock corporations and by the relevant provisions of the CVM, which to some extent overlap with company law. *See* ANTUNES (2009, 11-12).

7- DAVIES, P., SCHUSTER, E. and DE GHELCKE, E., "The Takeover Directive as a Protectionist Tool?" in *Company Law and Protectionism: New Challenges to European Integration*, 2010, Oxford University Press, London, 12-19.

8- That is, the value the shares would have if the company was managed efficiently.

9- The expressions "target company" and "target" shall be used in this study to refer to the company which is likely to be taken over by a bidder. The board of such company shall be referred to as the "target board".

10- The expressions "bidder" and "potential acquirer" shall be used as references to the investor who attempts to acquire the company by means of a takeover.

11- Terminology used by ARMOUR and SKEEL (2007, 1728).

12- In the U.S., defensive measures can be used if they are justified in accordance with the *business judgment rule*. However, this standard is only applicable if the directors prove that that there was a "*reasonable threat to corporate policy and effectiveness*" and that the measure adopted was a "*proportionate response*" (see cases *Unocal* and *Unitrin* of the Delaware courts). Most States have codes of laws which grant the board a significant discretion to use defensive tactics (*see* paragraph 23-2-35-1(d) of the Indiana Code). In the U.K., takeover regulation is driven by the preponderance of institutional investors, which explains why it is strongly oriented towards protecting the interests of shareholders and offering good investment protection (*see* Rule 21 of *The City Code on Takeovers and Mergers* (11th ed. 2013) -"Takeover Code"). *See* ARMOUR and SKEEL (2007, 1735).

13- According to WYMEERSCH, E., 2012, "A New Look at the Debate About the Takeover Directive", 2012, Ghent University, Financial Law Institute Working Paper nº 2012-05, 2 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1988927) the Takeover Bids Directive was conceived in a time when the dispersed ownership model was the company paradigm.

14- *See* art. 196º CVM. For a definition of the shareholders' exit right, *see* BAPTISTA, D., *O Direito de Exoneração dos Acionistas. Das suas causas,* 2005, Coimbra Editora, Coimbra, 84.

15- From the side of the sellers, by imposing a duty to share the control premium with the non-selling minority; and from the side of the potential acquirer, by imposing a duty to offer to buy the non-controlling shares at the same price as that obtained by the controlling shareholders. *See* Art. 194º, n.º2 and 197º CVM and DAVIES, P. and HOPT, K., "Control Transactions", *The Anatomy of Corporate Law – A comparative and functional approach,* 2nd Ed., 2009, Oxford University Press, New York, 257-260.

against the substantial influence of the controlling block.

However, these assumptions are not necessarily true due to high transaction costs, shareholders' incomplete information and the pressure to tender[16]. Also, corporate control transactions are executed for a variety of reasons and while the two mentioned above tend to enhance social welfare, other motives are purely value-decreasing[17]. Bidders might be driven by empire-building purposes (self-interest), thus overpaying for a takeover which will imply the sole creation of value for the acquiring company's shareholders or a higher compensation of its directors. Another tactic a corporate raider can use to generate large amounts money is to purchase enough shares in the target company to threaten a change of control, thereby forcing the company to buy its own shares back at a higher premium in order to suspend the takeover (the operation by which the company buys its own shares back constitutes an anti-takeover strategy known as the Greenmail or Goodbye Kiss[18]). Furthermore, stakeholders who are outsiders can stand to lose out on changes in the company's strategy (especially on the company's risk profile) implemented by the new board.

3.Specific Duties of the Board during a Takeover

The board neutrality rule[19]

Takeover regulation in European countries was harmonised by the EU Takeover Bids Directive[20]. The board neutrality rule is established under art. 9º, n.º2 of the Directive[21] and entails that during the course of a bid, the board of directors of the target company must refrain from taking any actions that materially change the company's net asset situation – namely, the issue of bonds and other securities that grant the right to their subscription or acquisition and the execution of agreements that aim to dispose of important parts of the corporate assets[22] -, are not included in the company's *day-to-day business*[23] and significantly affect the objectives

16- The European Commission has stated, in its *Report on the application of Directive 2004/25/EC, on takeover bids,* 2012, Brussels,4 (http://ec.europa.eu/internal_market/company/docs/takeoverbids/COM2012_347_en.pdf), that although in theory takeovers promote economic efficiency, economic analysis shows that in practice such assumption is not necessarily true. See also Marcus Partners in cooperation with the Centre for European Policy Studies, *Study on the application of Directive 2004/25/EC on takeover bids* ("*The Takeover Directive Assessment Report*"), June 2012, 278-279 (http://ec.europa.eu/internal_market/company/docs/takeoverbids/study/study_en.pdf).

17- ARMOUR and SKEEL (2007, 1739).

18- SILVA, J., *Estudos de Direito Comercial (Pareceres)*, 1996, Almedina, Coimbra, 238.

19- Some authors prefer to use the expression "*no-frustration rule*", arguing that the board is prohibited from frustrating the takeover before the shareholders have had an opportunity to decide whether they would like to accept or reject the bid, rather than a merely neutral position. In fact, the board is allowed to seek other offers (*white knight defence*) and is required to elaborate a report expressing its opinion on the merits and conditions of the bid. *See* VAZ, J., *A OPA e o Controlo Societário - A Regra da Não Frustração*, 2013, Almedina, Coimbra, 177-179, LEITÃO, L., "As Medidas Defensivas Contra Uma Oferta Pública de Aquisição Hostil" in *Direito dos Valores Mobiliários*, 2007,vol. VII, Coimbra Editora, Coimbra, 66, and CÂMARA P., "As Ofertas Públicas de Aquisição", *in Aquisição de Empresas*, 2011, Coimbra Editora, Coimbra,185). Other authors adopt the expression "*passivity rule*"- *See* SILVA J., "Nótula sobre a *passivity rule* e *optimal default* nacional em tempo de revisão da Directiva das OPA", *in Estudos em Homenagem a Miguel Galvão Teles*, 2012, vol. II, Almedina, Coimbra, 783-800.

20- The Directive allows three major options for national legislators: adopting the board neutrality rule or the breakthrough rule, or both; refusing to adopt one of rules, or both of them, while allowing companies to spontaneously comply with such rules (*opt back into* the provisions); adopting either of the rules, or both, but give the companies the power to escape those rules if the potential acquirer is not subject to the same restrictions (*reciprocity exception*). Germany adopted the second option, thereby allowing the board to adopt defensive measures upon approval by the supervisory board, or upon a preliminary general authorization by the shareholders (*Vorratsbeschüsse*, in § 33, 1 (1) and (2) of the *WpÜG*). Portugal and France (see arts. L. 233-32 (I) and L. 233-33 of the French *Code de commerce*) have adopted the third option. *See* VASSOGNE, T., LOY, M. and CARDI, B., "Implementation of the European Takeover Directive in France" *in The European Takeover Directive and Its implementation*, 2009, Oxford University Press, New York, 299-302) and VENTORUZZO, M., "The Thirteenth Directive and the Contrasts between European and U.S. Takeover Regulation: Different (regulatory) means, not so different (political and economic ends)?", 2006, Universitá Commerciale Luigi Bocconi,, 32, 50-51, 66 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=819764).

21- SILVA, J., (2012, 799-800), criticizes this option, arguing that Portugal should adopt the board neutrality rule as a *default rule*, while giving Portuguese companies the option to derogate this rule by a modification of its articles of association. This solution was adopted in Italy by *Decreto Legislativo 25 Septembre 2009, n.146, Disposizioni integrative e correttive del decreto legislative 19 novembre 2007, n. 229, recante attuazione della direttiva 2004/25/CE concernente le offerte publiche di acquisto*, in force since the 1st of July 2010.

22- Art. 182º, n.º2, *b)* CVM.

23- VAZ (2013, 225).

24- Art.182º, n.º2. This limitation of powers is extended to the directors' actions carrying out decisions taken before the relevant period and that have not yet been partially or completely carried out. *See* art. 182º, n.º2, *c)* CVM.

announced by the bidder[24]. These three cumulative criteria apply from the moment that the target board becomes aware of the decision of the bidder to acquire the company[25] to the moment when the end results of the bid are assessed or when the bid procedure ends, whichever occurs first[26].

Like some European jurisdictions[27], Portugal had established a *no-frustration rule* before the implementation of the Takeover Bids Directive, which is why the changes introduced in our jurisdiction only concerned the adding of the reciprocity exception[28]. The Portuguese legislator has established a general principle on the limitation of the powers of the target board during a takeover process[29] (board neutrality rule) in art. 182º of CVM.

The decision on whether to accept or reject the offer made by the bidder is consequently outside of the scope of the board of directors' functions[30]. Art. 182º CVM ensures that the market for corporate control functions efficiently[31] and allows shareholders to sell their shares and to exit the company should they consider the offer is wealth-enhancing - the addressees of the bid are the shareholders, which is why they are the ones who decide on the merits of the bid. The flip-side of the coin is, however, that the limitation of the powers of the board to build up defences for the company might lead to a lower premium to be offered to the shareholders in return of their shares. The incentive for companies to enter the market for corporate control (which is higher if they are allowed to shield themselves from changes of control), and the fact that Portuguese companies became more vulnerable to takeovers from companies which are not subject to the same limitations are other consequences[32].

There are, however exceptions to this rule, regarding actions that correspond to the fulfilment of obligations undertaken before the acknowledgement of the takeover bid and actions authorized by a resolution of a shareholders' general meeting exclusively convened for that purpose[33]. The board does not need, however, an authorization of the shareholders' general meeting to seek competing takeover bids

24- Art.182º, n.º2. This limitation of powers is extended to the directors' actions carrying out decisions taken before the relevant period and that have not yet been partially or completely carried out. *See* art. 182º, n.º2, *c)* CVM.

25- That is, when the target company receives the preliminary announcement of the bid. *See* art. 182º, n.º2, *a)* CVM. *See* CÂMARA P., *Manual de Direito dos Valores Mobiliários*, 2ª Ed., 2011, Almedina Coimbra, 590, and CÂMARA, 2011, "As Ofertas", 185.

26- Art. 182º, n.º1 CVM. Some authors, such as ENRIQUES, L., "European Takeover Law: The Case for a Neutral Approach", 2009, UCD Working Papers in Law, Criminology & Socio Legal Studies Research Paper nº 24/2010., 22-27 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1523307) criticize the option of EU policymakers on setting the board neutrality rule as a default rule. The same author argues the EU should adopt a neutral approach towards takeovers and help individual companies define their degree of control contestability, namely by requiring Member States to establish in their national laws that companies can grant directors a veto power on takeover bids. KIRCHNER, C. and PAINTER, R., "Towards a European Modified Business Judgment Rule for Takeover Law", 2010, 45-51(http://papers.ssrn.com/sol3/papers.cfm?abstract_id=247214) propose a *European modified business judgment rule* which would allow the target board to adopt defensive measures that are linked to the "best interest of the company, and particularly its shareholders" during a takeover attempt. The burden of proof should be on the side of the board, unless its actions are authorized by the shareholders.

27- Namely, Spain, Italy, France, Austria and the U.K. *See The Takeover Directive Assessment Report* (2012, 65- 66).

28- Upon the implementation of the Takeover Bids Directive, Portugal added the reciprocity exception, which allows the board of national companies to build up defences against companies which are not subject to the board neutrality rule. The purpose of this exception is to establish a level playing field for Portuguese companies. *See* arts. 182º, n.º 6 CVM and art. 12º, n.º3 of the Takeover Bids Directive.

29- It should be noted, however, that the board neutrality rule only applies to takeover bids launched over more than one-third of the securities of the same category as those that are object of that bid. *See* art. 182º, n.º1 CVM.

30- *See* art. 405º, n.º1 CSC.

31- *See the OECDE Principles of Corporate Governance,* 2004, 19 (http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf), where it is stated, in *Principle II. E* that "*Markets for corporate control should be allowed to function in an efficient and transparent manner*". It is clarified that "*Anti-take-over devices should not be used to shield management and the board from accountability*".

32- VAZ (2013, 140-141) and SILVA (2012, 799-800).

33- The general meeting is only empowered to legitimate the board for the practice of those acts if it is convened and held during the relevant period. The shareholders' resolution can only be taken by the *qualified* majority required by arts. 383º, n.º2 and 386º, n.º3 of the CSC (corresponding to at least 2/3 of the votes expressed) for the modification of the company's articles of association PINTO, Rita, "Implementation of the European Takeover Directive in Portugal" *in The European Takeover Directive and Its implementation*, 2009, Oxford University Press, New York, 630.

(*white knight defence*)[34]. In the situation of a hostile takeover attempt, the expression *white knight* refers to a company or individual which will launch an alternative bid at a higher price[35] with the purpose of preventing the hostile bidder from taking control of the target or to induce him to make another offer which is more favourable to the shareholders. The *white knight* will have the support of the management[36]. The *white knight defence* is allowed by art. 182º, nº3, *c)* of the CVM and by art. 9º, nº2 of the Takeover Bids Directive as an exception to the board neutrality rule, mainly because when the board seeks alternative bids it aims at getting a higher premium for shareholders in return of their shares.

Influence of the board

As a consequence of the transposition of the Takeover Bids Directive, the director's role when a takeover bid has already been made is an advisory one. The limitation of the powers of the board during a takeover process does not prevent it, however, from exercising its influence on the shareholders' decision to accept or reject the bidder's proposal, through a report where it states the conditions of the bid and expresses its opinion on its merits and opportunity. This is the most important mechanism for the board to influence the outcome of the bid, as it can recommend the shareholders not to sell their shares[37]. The minimum elements for such report are settled under Portuguese law in art. 181º CVM: it must contain a sustained autonomous opinion of the type and amount of the consideration offered, of the bidder's strategic plans for the company, of the impact of the bid - in the target company, generally, and on the interests of its employees, on its working conditions and on the places at which the company has business activity, in particular – and of the intentions of the members of the board who hold shares in the target company regarding the offer[38]. All the above-mentioned information should be clear, complete, up-to-date, truthful, objective and lawful[39]. The board is required to issue and send the report to the potential acquirer and the CMVM, as well as publicly disclose it[40]. Other collaboration duties are applicable to the behaviour of the members of the board during the course of a bid under art. 181º, nº 5 of CVM[41].

34- See art. 182º, n.º3, *a), b)* and *c)* CVM. Alternative bids are regulated in the CVM on arts. 185º, 185º-A and 185º-B.

35- According to art. 185º, n.º5 of CVM, the price of the offered by the *white knight* must be at least 2% higher than the one offered by the hostile bidder and cannot contain clauses which make it less favourable.

36- Nevertheless, the legal prohibition on financial assistance in the acquisition of its own shares is applicable to the target company, which is why the Portuguese Securities Market Commission (*Comissão do Mercado de Valores Mobiliários*, hereinafter "CMVM") has formally understood that the board cannot provide, even if only partially, financial assistance to any competing takeover bid. *See* CMVM, *Parecer Genérico da CMVM sobre os deveres de comportamento na pendência de Oferta Pública de Aquisição (OPA)*, 2006 I.2 (http://www.cmvm.pt/cmvm/recomendacao/pareceres/pages/20060321.aspx).

37- As an example of such influence, s*ee* CIMPOR, *Report of the Board of directors of CIMPOR on the opportunity and the conditions of the offer by INTERCEMENT (Camargo Corrêa)* of April 13 2012, 2012 (http://web3.cmvm.pt/sdi2004/emitentes/docs/FR38950). The Board did not recommend to shareholders to sell their shares, concluding that the price offered was low and significantly undervalued CIMPOR. Nevertheless, neither did the board recommend shareholders to maintain their investment in CIMPOR, as it did not have adequate information on the future of CIMPOR post-offer.

38- The negative votes issued in the resolution of the board of directors that approved the report should also be mentioned. Art. 181º, n.º3 CVM.

39- *See* arts. 7º and 181º, n.º5*, d)* CVM. The general rules of CVM concerning the disclosure of information by stock corporations are also applicable.

40- Within eight days of the receipt of the draft public offer announcement and draft prospectus, or within five days of the disclosure of an amendment to the offer documents. Art. 181º, n.º1CVM.

41- Such as the duty of disclosure to the CMVM of any information regarding the transmission of shares by the members of the board (held directly or in the terms of art. 20º CVM), the duty to disclose any other information required by the CMVM in its supervision, the duty to inform the employees' representatives (or in its absence the employees) of the impact the takeover bid will have on their interests and working conditions, of the contents of the offer's documents and of its report as well as, and the duty to "*act in good faith, concerning the accuracy of information and honest behaviour*"- Translation of VAZ, J., *A Regra da Não Frustração da OPA e a Aquisição do Controlo*, 2011 doctoral thesis at the Faculty of Law of the Univeristy of Coimbra, 8(https://estudogeral.sib.uc.pt/bitstream/10316/21125/3/Tese%20Final.pdf).

Defensive measures

The threat of a takeover to be launched over the company induces corporate directors and controlling shareholders to act in concert[42] and create strategies (defensive measures) which aim at preventing a potential takeover attempt or at frustrating an existing one. Indirectly, such measures provide some degree of protection to creditors who are not interested in the change of control over the company.

One can distinguish between two types of defensive measures[43]: *preventive* –adopted when there is no offer pending with the purpose of preventing future takeovers from happening (also referred to as *pre-bid defences* or *shark repellents*[44]) - and *reactive* defences (also named *post-bid defences*) – adopted after a takeover bid has been announced with the purpose of frustrating that specific takeover[45].

There are two possible motivations for the adoption of defensive measures: either the directors are only interested in keeping their jobs– *management entrenchment hypothesis*[46]- or they truly believe the price offered is not fair and that shareholders should get a higher price in return of their shares – *shareholder interest hypothesis*. In the second case, the management will try to increase the share value of the firm (*premium effect*[47]) – either by seeking alternative offers (*white knight defence*), or by forcing the hostile bidder to offer a higher price through the adoption of *post-bid* defences (such as the *poison pill*). In the EU, most jurisdictions have adopted the board neutrality rule, thus restricting the circumstances in which the board might adopt *post-bid* measures[48]. Such options clearly reflect the idea that although defensive measures might be considered a mechanism to negotiate the bid price, they may also operate to allow entrenchment of underperforming boards[49]. The adoption of *post-bid* defences is also restricted in Portugal, while *pre-bid* defences are generally allowed[50]. Special disclosure requirements apply to *pre-bid* defensive measures under art. 245º CVM[51]. Such disclosure requirements benefit stakeholders, such as future investors and corporate creditors[52], as they allow them to evaluate if the company has built appropriate defences or if, on the contrary, it is likely to have a change of control[53].

42- *See* Art. 2º, n.º1*, d)* of the Takeover Bids Directive for a definition of "persons acting in concert".

43- Terminology used by CORDEIRO, A., "Da Tomada de Sociedades (Takeover): Efectivação, Valoração e Técnicas de Defesa", 1994, *ROA,* 54,, 772 and ff, and VAZ (2013, 141 and ff.). For other defensive tactics classifications, *see* GUINE, O., *Da Conduta (defensiva) da Administração "Opada"*, 2009, Almedina, Coimbra,, 23-27.

44- LEITÃO (2007, 61).

45- In the framework established by the Takeover Bids Directive, the board neutrality rule (art. 9º) refers to the adoption of reactive tactics, while the *break-through rule* (art. 11º) is applicable to two specific types of preventive measures - the restrictions on the transfer of securities and on voting rights.

46- VAZ (2013, 157). *See* also LEITÃO (2007, 64).

47- The expression "premium" in the context of a takeover refers to the difference between the estimated market value of a target company's shares and the actual price paid by the bidder in order to obtain the control over the company. VAZ (2013, 160).

48- Such option contrasts with the one adopted by the U.S., where the board is granted a significant role in the takeover process.

49- *See* DAVIES and HOPT (2009, 265).

50- Except when the *breakthrough rule* is applicable. See art. 11º of the Takeover Bids Directive and art. 182º-A CVM.

51- This article implemented the obligations established for Member States under art. 10º of the Takeover Bids Directive. It was modified by D.L. n.º185/2009 of 12.08.09, which added other information duties, such as a declaration on the compliance with a corporate governance code or the reasons for non compliance (*comply or explain* approach regarding *soft law*) - *See* art. 245º-A, n.º1, *n), o)* and *p).*

52- *See OECDE Principles of Corporate Governance* (2004, 21) *Principle IV.D* – "*Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.*"

53- VAZ (2013, 164).

4. Corporate Creditors and the Target Company: Risks Borne in the Event of a Takeover

Agency problems[54] might arise between the shareholders and the company's creditors during a takeover, as the former are solely interest in getting the higher premium for their shares while the later are interested in company's overall value that guarantees their claim and bonds. To protect themselves against such risks, creditors use a range of covenants when celebrating bond or loan agreements (in addition to the basic obligations to repay principal and interest), which we shall examine further along in this study[55]. However, not all creditors have the capacity to impose the introduction of such provisions.

Creditor typology and bargaining power

Before focusing on the risks that creditors can face in the event of a takeover, it is important to distinguish between *strong* creditors and *weak* creditors. Contractual, commercial creditors (that is, *strong* creditors), namely banks, financial institutions, big trading corporations and bondholders[56] are powerful and able to negotiate the appropriate risk compensations with the corporate debtor. The main mechanisms used to ensure that the money they lend is repaid are contractual provisions (*covenants*)[57]. In contrast, involuntary creditors – namely tort victims, consumers and tax collectors – and some voluntary creditors – workers, small suppliers and small traders - lack such bargaining capacity (they are, consequently, *weak* creditors): this type of creditors is "*unable to contract around liability or to prepare adjustments to risk-shifting by negotiating some compensation in advance*"[58] and therefore more exposed to the risks caused by shareholders' decisions.

Risks borne by creditors in the event of a takeover

Considering the case of a takeover that causes the company's share value to drop, there are no doubts that creditors bear the burden of such depreciation, as their claims and bonds will consequently become less valuable. The changes of control operated through *Leveraged* or *Management Buy-Out*, provide two examples where the newly-owned company may not have the sufficient asset base to meet the corporate creditors' claims. The consequences of such operations will usually acquisition and, be that the company is saddled with repayment obligations arising from financing the consequently, its existing bonds are downgraded[59]. According to John Armour and David A. Skeel Jr., "*creditors may find the face value of their claims suddenly deflated by the target's having taken on a heavy debt burden to finance the acquisition or subsequent restructuring*"[60].

54- The modern version of the agency theory, as set out by ARMOUR, J., HERTIG, G. and KANDA, H., "Transactions with Creditors", *The Anatomy of Corporate Law – A comparative and functional approach,* 2nd Ed., 2009, Oxford University Press, New York,, 115 and ff., comprises three types of agency problems: between managers and shareholders, between majority and minority shareholders and between shareholder and non-shareholders (such as the company's creditors). *See* also JENSEN, M. and MECKLING, W., "Theory of the Firm: Managerial Behavior Agency Costs and Ownership Structure", *Journal of Financial Economics*, 1976, 3, 310.

55- *See* pp. 21 and ff.

56- When the company gives lenders bonds to secure its debts such creditors are referred to as "bondholders". *See* ARMOUR, HERTIG and KANDA (2009, 118). On bond issuing under Portuguese law, *see* CÂMARA (2011, *Manual ,* 134 -139).

57- DOMINGUES, P., *Variações sobre o Capital Social*, 2009, Almedina, Coimbra, 288. This study will focus on certain types of covenants – *see* pp. 21 and ff..

58- ANTUNES, J., *Liability of Corporate Groups - Autonomy and Control in Parent-Subsidiary Relationships in U.S., EU and German Law. An International and Comparative Law Perspective*, 1st Ed., 1994, Kluwer Law International, Boston, 135.

59- An example of a complex Leveraged Buyout which resulted in a downgrade of the bondholders' bonds was the case RJR Nabisco. *See* OSÓRIO, D., *Da Tomada de Controlo de Sociedades (Takeovers) por Leveraged Buyout e a sua Harmonização com o Direito Português*, 2011, Almedina, Coimbra, 33, footnote 13.

60- ARMOUR and. SKEEL (2007, 1739).

A *Leveraged Buyout* (LBO) occurs when the target company's assets are used as collateral to purchase the company itself[61]. The financial sponsor will partially finance the acquisition with borrowed capital (usually bank debt), secured by the company's assets or its capacity to generate future cash flows[62]. Consequently, the purchase costs will be transferred to the company itself. The ratio of the company's debt to its equity is called *leverage ratio*[63], and the higher the leverage, the higher the returns will be for the financial sponsor, thereby creating an incentive to employ as much debt as possible to finance the acquisition. As a consequence, the surviving entity will be privately held[64] and highly leveraged (a *shell corporation*[65]), and if it does not generate sufficient profit to service the debt there is a high risk of insolvency. A particular type of leveraged acquisition is the *Management Buyout* (MBO), when the incumbent management acquires all or a sizeable portion of the company's shares by means of a merger with a newly formed company created by them. The funding is provided by debt or securities, also secured by the target's assets or future cash flows (MBO are usually highly leveraged acquisitions)[66].

Additionally, creditors' guarantees might be harmed as a result of the new owners' business decisions[67] . Usually such decisions only seek to enhance shareholder wealth, without considering the consequences for other constituencies and for the company itself. The adoption of riskier strategies has a strong potential to reduce the overall value of the firm's assets and consequently of its debt finance, thereby harming creditor interests. Some examples of riskier strategies shareholders might engage in that can harm creditors' claims over the company[68] are *asset substitution*[69] - selling assets used in low-risk business activities to pay for the acquisition of assets to be used in high-risk business activities - and *debt dilution* or *claim dilution*[70] - increasing the company's overall borrowing.

5.The Interests of Creditors in the Light of Directors' Duties during a Takeover

Bearing in mind that the actions of the board of directors during a takeover are restricted by the board neutrality rule, it is important to point out that directors are still bound to pursue the interest of the company. We finally reach the main

61- OSÓRIO (2011, 79).

62- *Ibdem*

63- BRATTON, W., "Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process", *European Business Organization Law Review,* 2006, 7, 55 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=902910).

64- *See* the distinction made on footnote 6.

65- BRATTON (2006, 55).

66- Some financing instruments used are bonds (art. 348 and ff. of CSC), convertible bonds (art. 365 and ff. of the CSC), no-voting stocks (art. 341 and ff. of CSC) and secured bank loans (such as mortgage loans). Some techniques which can be adopted consist on the issue of shares and warrants, the sale leaseback and the use of equity investment funds and of employee stock option plans. *See* OSÓRIO (2011, 99 -114).

67- The potential acquirer's intentions with regard to the future business of the target company must be disclosed in the offer document, in the terms of art. 6º, n.º3, *i)* of the Takeover Bids Directive.

68- SMITH and WARNER (1979, 117-118). *See* also NASH, NETTER, and POULSEN (2003, 203-204).

69- ARMOUR, HERTIG and KANDA (2009, 116). In the case of *asset substitution*, there will be a change in the company's risk profile. Shareholders can benefit from an increase in the riskiness of the firm's business, by receiving more dividends if the value of future cash flows increases. On the other hand, if such value decreases, shareholders will not be harmed, as they cannot lose more than the value of their shares (as a consequence of the company's limited liability). Creditors, on the other hand, have fixed claims against the company, which means that even if more profit is generated, they will not receive more than what was contractually stipulated. And, of course, the riskier the company's profile, the greater the chance it will not generate sufficient cash flow to pay them. The company needn't even to default on its obligations for the interests of creditors to be harmed: the increase of the riskiness in the debtor's business activity will imply a decrease on the value of the creditors' claims in secondary loan markets.

70- ARMOUR, HERTIG and KANDA (2009, 117). The more creditors a company has, the lower will the expected recoveries for such creditors be should the firm default. The new borrowing will be subsidized by the existing lenders.

question of our research: what interests should be considered by the board during a takeover?

The Takeover Bids Directive

Article 3º, nº1, *c)* of the Takeover Bids Directive encompasses an obligation for the board of a target company to "*act in the interest of the company as a whole*". Nevertheless, there is no pan-European consensus on the concept of "*interest of the company*"[71].

Such provision of seems to call for a proportionality test between of the former unclear, as there is no provision regarding how the conflicts between the interests of stockholders and stakeholders might be resolved. Is the practical effect of the Directive that the board is entitled to take into account a broader range of interests beyond the shareholders' interests when advising on a bid, but is not bound to do so?

One could argue that the term was deliberately left vague as a political compromise, allowing each Member State to interpret it within its own tradition: some authors suggest that the limits of what the board is allowed to do in order to comply with art. 3º, nº1, *c)* without jeopardizing the *neutrality* principle are to be settled by national laws[72]. It is also impossible to overlook the barriers to a complete harmonisation of takeover regulation within the EU[73], as the "*flexible framework*"[74] that the Directive introduces was unsuccessful in achieving the objective of creating a level-playing field for European companies[75].

Nevertheless, an autonomous interpretation within the context of the Directive is required[76], which is why we agree with the perspective that envisions the term in a wider sense, going beyond the interests of the shareholders as a class and allowing broader stakeholder interests - such as creditors' rights – to be taken into account[77].Whatever the target company's shareholding structure is, agency problems always arise between the potential acquirer and non-shareholders, especially creditors and employees. There is a legal obligation to take into account the interests of such constituencies, which gives rise to directly enforceable rights under art. 17º of the Directive[78] - and not just

71- SJÅFJELL, B., "The Core of Corporate Governance: Implications of the Takeover Directive for Corporate Governance in Europe", 2010, UCD Working Papers in Law, Criminology & Socio Legal Studies Research Paper nº 27/2010, 8 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1598298).

72- *The Takeover Directive Assessment Report* (2012, 105).

73- *Though some literature announces a convergence towards the UK model – see* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=709023 *- GOREGEN, M., MATYNOVA, M. and RENNEBOOG, L., "Corporate Governance Convergence: Evidence from Takeover Regulation Reforms", 2005, ECGI – Law Working Paper nº 33/2005, 29, and VENTORUZZO (2006, 33).*

74- WOUTERS, J., VAN HOOGHTEN, P. and BRUYNEEL, M., "The European Takeover Directive: a commentary", in *The European Takeover Directive and Its implementation*, 2009, Oxford University Press, New York, 3-76.

75- The distinct features of corporate governance systems lead to another debate on whether Europe should aim at building an harmonised model or if there should be a neutral position from the Commission, allowing Member States to choose the system that better suits their corporate governance traditions. *See* TSAGAS, G., "EU Takeover Regulation: one size can't fit all" *in International Journal of Private Law,* 2011, Vol. 4, No. 1, 173, 182.

76-On the principle of autonomous interpretation, *see* PAIS, S., *Princípios Fundamentais de Direito da União Europeia- Uma abordagem jurisprudencial*, 2ª Ed., 2012, Almedina, Coimbra, 91-106.

77- In 1997, the *Amended proposal for a Thirteenth European Parliament and Council Directive on company law concerning takeover bids* (COM (97) 565 final, 5), stated that "*the board must act in all the interests of the company, including those of shareholders, creditors and employees, particularly with a view 'to safeguarding employment*". *See* also *The Takeover Directive Assessment Report* (2012, 105) and

78- SJÅFJELL (2010, 8), who argues that "*if the principle in art. 3º, n.º1, c) is to have any real meaning, it can hardly be interpreted simply as meaning that the board should take care of the interests of the shareholders as a whole*", as the board neutrality rule is already intended to ensure that the board does not hinder takeovers and allows shareholders to have the ultimate decision on the outcome of the bid. SJÅFJEL (2010, 12).

the possibility of considering such interests.

The debate on the concept of "interest of the company"

Literature has adopted different perspectives of which interests should be included in the concept of "*interest of the company*" in the event of a takeover.

A) *The shareholder primacy view* **and the** *enlightened shareholder value*

Under a *contratualist* approach, the definition of company interest would be restricted to "*the interest of the shareholders as a class that the firm maximizes its value and consequently is able to distribute dividends*"[79]. This position is also referred to as the "*shareholder primacy view*"[80] and prevailed in the Anglo-American corporate law systems (or *shareholder-oriented models*), due to the more advanced state of the market for corporate control in such jurisdictions[81]. An evolution of this perspective called *enlightened shareholder value* is adopted in the UK[82]. Following the *enlightened shareholder value* approach, corporations should pursue shareholder wealth with a long-run orientation that seeks sustainable growth and profits based on "*striking a balance"*[83] between the competing interests of the different stakeholders. The board's ultimate responsibility is to the shareholders as a class but it is required to pursue that objective with regard to long-term consequences, employee interests, relations with suppliers, customers and others, impact in the community and environment and the company's ethical reputation. In the context of a takeover, however, shareholder interests seem to come to the forefront, which leads to a shorter-term focus on current share-price and to the restriction of the powers of the board[84].

B) The *institutional view*

In contrast to the *contratualist* view, the *institutional theory* encompasses that the need for the firm to be efficient determines that its interests do not correspond to the interests of the shareholders as a class. This view considers that companies play a fundamental social role of helping the development of a community's Economy. The company is seen as a separate economic agent (theory of *Unternehmen an sich*[85]), with interests which go beyond the direct interests of the shareholders. The interests of the company represent the common interests of shareholders, employees, creditors, suppliers and customers. Some European countries adopt this company-oriented approach[86].

79- XAVIER, V., *Anulação de Deliberação Social e Deliberações Conexas*, 199l, Almedina, Coimbra, 242 and ff.

80- *See The Takeover Directive Assessment Report* (2012, 32) and JENSEN, M. and MECKLING, W., "Theory of the Firm: Managerial Behavior Agency Costs and Ownership Structure", *Journal of Financial Economics*, 1976, 3, 976, 305 and ff..

81- In Spain, the Spanish Supreme Court has held that art. 226 of *Ley de Capital* (that refers to the interest of the company- "*interés social*") must be interpreted in line with shareholder primacy. *See* GERNER-BEUERLE, C., PAECH, P. and SCHUSTER, E., *Study on Directors' Duties and Liability prepared for the European Commission DG Markt,* 2013, London School of Economics, London, 74 (http://www.ecgi.org/codes/documents/libro_bianco_cgov_pt.pdf).

82- *See* section 172 (1) of the *2006 Companies Act*. The core mechanisms of UK corporate governance (such as hostile takeovers, directors' duties and board structure) are highly shareholder-oriented, which leads to the prevalence of the interests of shareholders over the interests of other stakeholders, such as employees and creditors. *See* ARMOUR, J., DEAKIN, S. and KONZELMANN, S., "Shareholder Primacy and the Trajectory of UK Corporate Governance", 2003, ESRC for Business Research, University of Cambridge, 3-6 (http://www.cbr.cam.ac.uk/pdf/WP266.pdf).

83- *See* U.K. Company Law Review Steering Committee, *Modern Company Law for a Competitive Economy: The Strategic Framework,* 1999, London, 139 (http://www.berr.gov.uk/files/file23279.pdf).

84- *See* Rule 21 of the *Takeover Code.*

85- RIBEIRO (2012, 510, footnote 1).

86- In France, art. 1848 of the *Code Civil* refers to the interest of the company ("*l'interêt de la societé*") to guide the directors when managing the company. Such expression has also been discussed in this legal system. *See* GERNER-BEUERLE, PAECH and SCHUSTER (2013, 68).

C) The *stakeholder model*

Finally, there is a growing acceptance towards the idea that "*acting in the interest of the company*" requires that the interests of all affected constituencies are valid in their own right, rather than as a means of achieving shareholder value. The same logic is applicable when discussing the company's environmental responsibility[87]. The interests that should guide the management are not only the interests of the shareholders as a class, but also the interests of other constituencies, such as employees, creditors, suppliers, customers and of local communities and authorities which can be affected by the company's sustainability– the *stakeholders*. According to the European Commission[88], a *stakeholder* is "*an individual, community or organisation that affects, or is affected by, the operations of a company*". Stakeholders can be internal (e.g. employees or shareholders) or external (e.g. customers, suppliers, creditors and the local community)[89]. This *pluralistic* view is also referred to as "*stakeholder model*"[90], and is adopted in some jurisdictions to determine the directors' general fiduciary duties[91].

The *stakeholder view* holds that taking into account the interests of non-shareholder constituencies will benefit the shareholders on the long-run: the firm's global value is likely to increase if its contractual relationships with those individuals are maintained and if new relationships are established. This formulation does not mean, however, that directors should only pursue the interests of stakeholders, or that such interests shall prevail over the interests of shareholder on the long-run: the primary goal of the board should be, at all times, maximizing the firm's wealth. But managing the company calls for a *proportionality test*, and directors should avoid that the decisions which aim at pursuing the long-term interests of the shareholders cause an unreasonable sacrifice to other constituencies.[92]

The debate on the definition of "interest of the company" in Portugal

Under Portuguese law, the debate on which interests are included in the "*interest of the company*" is centred in the *general fiduciary duty of loyalty*, established under art. 64º, nº1, *b)* of

87- According to EIJBOUTS, I., "Corporate responsibility, beyond voluntarism- Regulatory options to reinforce the licence to operate", 2011, Maastricht University, 35, 49-50 (http://www.l4bb.org/articles/OBS_7885_-_Eijsbouts_digitale-1.pdf), the normative version of the stakeholder theory is based on ethical perspectives.

88- *See* European Commission, *Green Paper - Promoting a European framework for Corporate Social Responsibility,* 2001, Brussels, 25 (http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001DC0366&from=EN).

89- Other types of stakeholder classification can be adopted, namely the one used by SERRA, C., "Entre *Corporate Governance* e *Corporate Responsability*: deveres fiduciários e *interesse social iluminado*", I Congresso Direito das Sociedades em Revista, 2011, Almedina, Coimbra, 213-214, between contractual- shareholders, employees, business partners, suppliers, customers and creditors - and collective stakeholders – the local community, organisations, national authorities or the government.

90- NUNES (2012, 441 and ff.) and RIBEIRO (2012, 509 and ff.).

91- *See* s. 93(1) *AktG* for Germany.The regulation of defensive measures is consequently more relaxed than in the UK. *See The Takeover Directive Assessment Report* (2012, 64). *See* GERNER-BEUERLE, PAECH and SCHUSTER (2013, 68).

92- If two decisions with the same impact on shareholders are available, the one which is most favourable to the stakeholders should be adopted. SERRA (2011, 246-250).

CSC[93]. Such provision states that directors and auditors must "*pursue the company's interest taking into account the long term interests of theshareholders, while considering the interests of other stakeholders, such as employees, clients and creditors*"[94 95].

When the board of directors advises the shareholders on a takeover bid or adopts certain strategies and defensive measures to frustrate a takeover attempt, their actions must be seen in the light of the general fiduciary duties ("*deveres fiduciários gerais*")[96] established under art. 64º CSC[97]. Such duties constitute a central aspect of corporate governance[98] and are equally binding for the management of public corporations.

Art. 64.º CSC outlines two general fiduciary duties: a *duty of care* ("*dever de cuidado*"), on the one hand, and a *duty of loyalty* ("*dever de lealdade*"), on the other. The *duty of loyalty* encompasses that corporate directors or managers of a company must put the company's interests ahead of their own[99]. If corporate directors breach one of the general duties, they will be liable towards the company for not pursuing its interests (being that such claim can also be filed by the company's creditors- art. 78º CSC)[100].

For this reason, it is important to assess whether the *fiduciary duty of loyalty* requires the board to take into account the creditors' interests during a takeover attempt and whether such duty is breached if directors do not exercise their influence to frustrate a bid which they believe to cause a substantial damage to those interests.

The Portuguese literature traditionally adopted the *contratualist* approach[101], only considering the interests of non-shareholder constituencies if they are aligned with the interests of the shareholders as a class[102]. For such authors, the interests of non-shareholder constituencies, such as employees and creditors, and the personal interests of shareholders – as mentioned

93- Other provisions from the CSC refer to the company interest, such as arts. 6º, n.º3, 251º, 328º, n.º2,*c)*, 329º, 2, 400º, n.º1, *b)* and 460, n.º2. *See* ABREU, J., *Da Empresarialidade - As Empresas no Direito*, 1996, Almedina, Coimbra, 226. This study shall only analyze art. 64º, n.º1, *b)*, as it also binds the members of the board during a takeover.

94- Art. 64º, n.º1: "*Os gerentes ou administradores da sociedade devem observar:…(b) Deveres de lealdade, no interesse da sociedade, atendendo aos interesses de longo prazo dos sócios e ponderando os interesses dos outros sujeitos relevantes para a sustentabilidade da sociedade, tais como os seus trabalhadores, clientes e credores*". In the Spanish *Ley de Sociedades Anónimas*, modified by *Ley 26/2003*, of 17.07., art 127- *bis* establishes that directors must perform their duties in the pursue of the social interest. Such interest is merely defined as the "interest of the company", which also caused Spanish authors to discuss which interests should be taken into account by corporate directors during a takeover. Daniel Ruiz de Villa argues that the interpretation of art. 3º, *c)* of the Takeover Bids Directive and of the Introduction of *Ley del Mercado de Valores*, of 24.07.88, allow for a wider conception of the interest of the company. *See* RUIZ DE VILLA, D., "Los limites legales a la actuación de los administradores de la sociedade opada (art. 60 bis LMV y desarrollo reglamentario)", *Monografía de Revista de Derecho de Sociedades*, vol. 35, 2010, Thomson Reuters-Aranzadi, Navarra, 31-33.

95- The original version only mentioned the interests of shareholders and employees. A reform was operated by D.L.n.º 76-A/2006, of 29.03.06. A similar evolution took place in the U.K. jurisdiction, with the introduction of section 172 (1) of the *2006 Companies Act*.

96- VAZ (2013, 131).

97- Art. 64º, n.º1, *a)* refers to the duty of care and skill and art. 64º, n.º1, *b)* refers to the duty of loyalty. This is the text arising from the reform brought by Decree-Law n.º 76-A/2006, of 29.03.06, in which there was a specification of the fundamental duties according to which the management of the firm should guide itself. João Calvão da Silva argues that the bifurcated concept arising from the reform is a mere *legal transplant* of the common law concept of «fiduciary duty». *See* SILVA, J., "*Corporate Governance* - Responsabilidade Civil dos Administradores não executivos, da Comissão de Auditoria e do Conselho Geral e de Supervisão*"* 2006-2007*, RLJ*, Coimbra Editora, Coimbra, n.º 3940, 33, and WATSON, A., *Legal transplants. An approach to comparative law*, 2ª Ed., 1993, University Press of Virginia, Virginia, 91.

98- *See Principle VI.A.* of the *OECDE Principles of Corporate Governance* (2004, 24).

99- *See* NUNES, P., *Responsabilidade dos administradores perante acionistas*, 2001*,* Almedina, Coimbra, 89. There is a breach of this duty when directors divert corporate assets, opportunities, or information for personal gain. *See* ABREU (2012, 136-139).

100- Also, according to ESTACA, J., *O Interesse da Sociedade nas Deliberações Sociais*, 2003, Almedina, Coimbra, 182, and ANTUNES (2009, 36-37), the violation of the company's interests by the directors can be accepted as a just cause of removal. *See* Art. 403º, n.º1 of CSC.

101- According to NUNES, P., *Corporate Governance*, 2006, Almedina, Coimbra, 33, footnote 45.

102- *See,* among other authors, XAVIER (1991, 168 and ff., footnote 76; 242 and ff., footnote 116), NUNES (2001, 85 and ff.), ABREU, J., "Deveres de cuidado e lealdade dos administradores e interesse social*", in Reformas do Código das Sociedades*, 2007, Almedina, Coimbra, 33, TRIUNFANTE, A., *A Tutela das Minorias nas Sociedades Anónimas. Direitos de Minoria Qualificada. Abuso de Direito*, 2004, Coimbra Editora, Coimbra 212 and ff., 224 and ff.. GUINÉ (2009, 80-83) and CORDEIRO, (1994, 58). In the Portuguese case-law, see case 208/99 of the Lisbon Civil Court - Processo 208/99, da 3ª Vara, 1ª Secção da Comarca de Lisboa *in CJSTJ*, 2003, ano XI, tomo III, 17 a 27.

in art. 64º, nº1, *b)* – should be taken into account as mere limitations to the directors' duty to pursue the company's interest in maximizing its value[103]. The institutional view[104] and the stakeholder view[105] are also present amongst Portuguese literature.

The question of which interests should guide directors when a takeover bid is launched over the company has been approached by some authors who offer a *contratualist* solution to the problem. To these authors, if, in the event of a takeover attempt, the interests of the shareholders as a class is not aligned with the interests of other constituencies, the former shall prevail, as it is the owners of the company that should be protected primarily, leaving no room for the consideration of creditor interests[106].

Critical analysis

Bearing in mind the considerations made above, we believe the *stakeholder view* to be the correct perspective to adopt in the discussion of which interests should guide the board of directors while managing the company. In fact, if the board only seeks to maximize shareholder wealth while managing the company, it will adopt riskier investment strategies without considering the consequences on other constituencies. Such actions can have negative consequences in the company's assets and consequently on its financial situation, thereby affecting creditors.

In the particular context of a takeover, this problem becomes even more relevant: as it was demonstrated, corporate restructuring, especially when operated through LBO or MBO, can lead to the depreciation in the target company's share value, causing creditors' claims and bonds to become less valuable.

The vague reference made in art. 3º, nº1, *c)* of the Takeover Bids Directive to the "interest of the company as whole" has compromised a harmonised understanding, leading to different interpretations of the term and to similar formulations at national level (such as art. 64º, nº1, *b)* of the CSC). But as soon as one realizes that a takeover constitutes one of the most important decisions for the company's business, one concludes that interests other than the ones form the shareholders should be taken into account, such as the interests of the company's creditors.

With this guideline in mind, we finally reach the thesis defended in the present study: the risks borne by corporate creditors in the event of a takeover, together with the fact that they are important financers to the company, justifies a stronger protection of their position during the course of a bid. Naturally, such protection must comply with the board neutrality rule established at EU-level[107]. In other words, although directors' powers during a takeover process are limited, they will still be bound to the core *duty of loyalty*, which requires them to act with the interest of the company in mind, which

103- VAZ (2013,128-131 and 2000, 33-35), considers that the interests of non-shareholder constituencies play a secondary role in the directors' decisions and can only be attended so far as they do not conflict with the interest of a sustained creation of wealth to the shareholders.

104- *See*, namely, ESTACA (2003, 93 and ff., 106 and ff.) and ALMEIDA, A., "Estrutura organizatória das sociedades*" in Problemas do Direito das sociedades*, 3ª Ed., 2003*,* Almedina, Coimbra, 50 and ff., who argues that the "interest of the company" is the interest of the firm while pursuing its commercial activity. To ASCENSÃO, J., *Direito Comercial. Vol. IV – Sociedades Comerciais*, 2000, Faculdade de Direito de Lisboa, Lisboa, 446-447, the "interest of the company" corresponds to the combination of the interests of the shareholders acting as such and the interests of the employees.

105- *See* FRADA (2007, 217), CUNHA, P., *Direito das Sociedades Comerciais*, 4ª Ed., 2010, Almedina, Coimbra, 41, 570 and ff. *See* also Instituto Português de *Corporate Governance*, *Livro Branco Sobre Corporate Governance em Portugal*, 2006, 141-142 (http://www.ecgi.org/codes/documents/libro_bianco_cgov_pt.pdf).

106- *See* VAZ (2013, 186-19)1 and GUINÉ (2009, 69). According to this last author, the company is an instrument used by its owners, which is why its management should be guided by the interests of the shareholders.

107- The protection of creditors does not justify the abolition of the board neutrality rule in order to grant directors the power to reject a takeover bid. To do so would accentuate the *management entrenchment* risks and affect the efficiency of the market for corporate control.

includes the interests of its creditors.

Moreover, this duty grants the board more discretion when facing a bid, allowing it to exercise its influence[108] to thwart a takeover that is considered harmful for the company's creditors - as long as the consideration of such interests does not put the company's sustainability at stake. We consider that the board must take into account the interests of stakeholders during a takeover process, when it predicts that without a decision favouring those interests they would be substantially harmed and without a corresponding benefit to the shareholders. If directors do not exercise their influence to deter a takeover which will most likely affect the company's financial situation and the position of the company' creditors, legal standing can be exercised on the basis of arts. 17º of the Takeover Bids Directive and 78º of the CSC[109].

The consideration of other interests by the management is one of the reasons for admitting the use of defensive measures by the board in the *constituency statues* adopted by some U.S. States[110]. In Europe, a reference should be made to the Belgian legal system, where it was understood that the board of directors should assess the merits of the bid in the light of the interests not only of the shareholders but of all stakeholders[111]. Nevertheless, an *enlightened shareholder* approach of the duties of corporate directors during a takeover still prevails in Portuguese and international literature, which is why we will next focus on additional legal and contractual solutions that grant creditors some protection.

6.Contracting Around Takeovers

Creditors such can anticipate the risks of default of the corporate debtor by introducing certain types of contractual clauses (*covenants*) in their indentures and bonds[112]. Covenants can increase the firm's value at the time bonds are issued or that the debt contracts are celebrated, but they also impose costs on the issuing firm, especially the loss of flexibility when deciding on its investment and financing opportunities.

The ability of creditors to negotiate such clauses depends, however, on the number and identity of creditors[113]: it is harder for a large number of bondholders to renegotiate contractual provisions than for a few banks; also, only *strong* creditors[114] such as banks and financial institutions are in position to introduce these type of clauses in their lending agreements, as they can refuse to grant the loan or demand higher interest rates if the debt contracts do not include such clauses[115].

108- The influence of corporate directors in the shareholders' decision concerning the offer is exercised through the mechanism described on pp. 7-8.

109- If directors suspected that the asset base of the company will be diminished as a consequence of a takeover and do not try to stop it, they will be liable towards the company, being that such claim can also be filed by the company's creditors via sub-rogation (art. 78º, n.º 2 CSC).

110- In the US legal system the directors are not subject to an obligation of neutrality and are empowered to decide on the merits of the bid. *See* paragraph 23-2-35-1(d) of the Indiana Code, according to which "*A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors the director considers pertinent*". *See* GUINÉ (2009, 82, footnote 145).

111- *See* Royal Decree of 14 November 2007 *on the obligations of issuers of financial instruments admitted to trading on a regulated market*. Nevertheless, some authors consider that a stakeholder interpretation of the interest of the company is only appropriate in crisis situations - GERNER-BEUERLE, PAECH and SCHUSTER (2013, 66).

112- The *costly contracting hypothesis* - SMITH, C. and WARNER, J., "On Financial Contracting: An Analysis of Bond Covenants", *Journal of Financial Economics* 1979, 7, 117-122.

113- SMITH and WARNER (1979, 5).

114- *See* the distinction between *strong* and *weak* creditors on p. 11.

115- GUINÉ (2009, 47).

Literature outlines two broad categories of covenants[116]: the ones that restrict dividend and financing activities and the ones that restrict restructuring or investment decisions. The second type of covenants are usually included in bond issues and lending agreements to protect creditors against changes of control in a company's structure. Some examples are event-risk[117] covenants in bond issues - which protect creditors against risks of claim dilution resulting from a LBO or MBO[118], change of control provisions and merger covenants conditioning the merger to the survivor's ability to borrow under the debt contract *ex post* the closing of the merger.

Change of control provisions

Change of control provisions (or *poison puts*) are contractual provisions which give a party to the agreement the right to terminate the contract (or to demand a higher interest rate)[119] in the event of a change of control of the other party. The condition that triggers the *poison put* is the change of control itself: the acquisition or holding, directly or indirectly, by another company or by an individual, of more than fifty percent of the voting share capital of the company or the ability to appoint or dismiss all or the majority of the members of the board of directors or of the supervisory body[120], or the acquisition or holding of a number of voting rights that trigger the obligation to launch a mandatory takeover bid[121]. In some contracts the events mentioned above must be accompanied by a downgrade on the company's debt for the contract to be lawfully terminated[122]. As far as formal requirements are concerned[123], art. 245º -A, nº1, *j)* CVM establishes that change of control provisions must be disclosed by the company[124, 125].

When such clauses are included in financing agreements, can demand the repayment of the principal amount of the loan with interest or to cancel any obligation to grant future loans in the event of a takeover - *poison puts* are seen as acceleration clauses[126], as debt becomes due and payable upon their violation.

The inclusion of such clauses in bond contracts or in a lending agreement grants the lender (usually the company's bank) a significant degree of control over the company: they protect his interest that the ownership and control of the company remain substantially unmodified and allow him to terminate the financing agreement if it doesn't.[127].

116- *Idem*, 125-139. *See* also NASH, R., NETTER, J. and POULSEN, A., "Determinants of contractual relations between shareholders and bondholders: investment opportunities and restrictive covenants", *Journal of Corporate Finance*, 2003, 9, 213-229.

117- According to BRATTON (2006, 44), "event-risk" is "*the bond market's term for leveraged restructuring and other cases where a highly rated bond issuer changes its risk profile for governance reasons unrelated to the fundamentals of its business*".

118- NASH, NETTER and POULSEN (2003, 204).

119- GUINÉ (2009, 46).

120- In the three-tier system. *See* footnote 2.

121- DUBOUT, H., "Les clauses de changement de contrôle" in *Les grandes clauses des contrats internationaux. 55ème Seminaire de la Commission Droit et vie des Affaires*. 2005, Bruylant, Bruxelles, 335-336.

122- NASH, NETTER and POULSEN (2003, 224).

123- According to DUBOUT (2005, 343), there are mainly two alternative connecting factors to find the applicable law on what concerns issues of company law: either the law of the *principal seat* of the company (that is, the place where the most important decisions are taken and from where the management operates) or the law of the country where the company has been incorporated – VAN HOUTTE, H., *The Law of International Trade*, 2nd Edition, 2002, Sweet & Maxwell, London, 18.

124- *See* art. 10º, n.º1, *j)* of the Takeover Bids Directive and Recommendation I.6.2 of *Código de Governo das Sociedades da CMVM* (2010, 2). Art. 350º of CSC states that the emission of bonds depends on the approval of the general meeting, but the company's articles of association can also delegate such power on the board. *See* also art. 366º CSC.

125- Under Belgian law, for such clauses to be lawful they will have to be approved by the general meeting, besides of being disclosed by the company. *See* art. 566 of the Belgian *Code des societés,* of 07.05.99, and DUBOUT (2005, 342-344).

126- *See* ARMOUR, HERTIG and KANDA (2009, 124).

127- DUBOUT (2005, 330-331) - "*il s'agit bien de «fabriquer» contractuellement un intuitu personae qui n'existe pas naturellement dans les engagements pris par les personnes morales*".

Merger restrictions

Restrictions on mergers mitigate creditor expropriation by *asset substitution*[128] as they provide obstacles to the management's attempt to undertake riskier projects after issuing their bonds.[129] Some covenants contain flat prohibitions on mergers, while others only specify conditions for such activities[130]. A typical merger restriction covenant allowed under Portuguese law is the clause in a loan agreement that states that if the debtor is subject to a merger it must immediately return the principal amount (art. 101º-B, nº 3 CSC).

7. Concluding Remarks

As a consequence of the adoption of a board neutrality rule by the Portuguese legislator, the managing board has a mere advisory role during a takeover process, although it can exercise a significant influence on the shareholders' decision through the report it elaborates on the conditions, opportunity and merits of the bid and through the adoption of other tactics referred to in this study. Some authors argue that a broader discretion should be given to corporate directors in such circumstances, arguing that if the decision on whether to accept or reject the bid is allocated to the shareholders, they will most likely sell their shares if the offer is wealth-enhancing. But the change of control itself might cause the share-value to drop, and consequently the depreciation of creditors' claims and bonds. On the other hand, the fact that the price offered maximizes shareholder wealth on the short-run does not necessarily mean it constitutes the best choice for the company and for its creditors in the long-run, especially if the bidder's intentions with regard to the future business of the company includes the adoption of riskier strategies.

The Takeover Bids Directive's vague reference to the interests of non-shareholder constituencies in the event of a takeover makes it difficult to reach a consensus on whether there is a legal obligation for corporate directors to exercise its influence to frustrate the bid when they believe it to be beneficial for shareholders but prejudicial for the company's creditors. We believe a *stakeholder view* should be adopted in the discussion of which interests should guide the board of directors in the event of a takeover, as the general fiduciary duty of loyalty towards the company also bounds directors during a takeover, which is why we defend that they should consider the effects of the takeover on the creditors' claims and rights.

It is also important to refer to the contractual means that can grant some creditors protection in such cases. An example of covenant that can be used by *strong* creditors to thwart a takeover attempt is the change of control provision introduced in the financing agreements.

128- See p. 12.

129- NASH, NETTER and POULSEN (2003, 224).

130- Some requirements state that the successor must assume all the obligations in the initial debt contract or that the value of creditors' claims is not reduced due to the effect of a difference in variance rates or in capital structures. *See* SMITH and WARNER (1979, 129).

CMVM

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