



The Enterprise Chamber's decision on PCM

POTENTIAL EFFECTS ON LEVERAGED BUYOUTS IN HOLLAND

The Enterprise Chamber of Amsterdam's Court of Appeal has given a decision whose implications extend beyond the companies involved in the case. It may affect how leveraged buyouts are structured and how portfolio companies of private equity sponsors need to be managed. This briefing outlines the decision's main implications.

Introduction

On 27 May 2010 the Enterprise Chamber of the Amsterdam Court of Appeal rendered an important decision in relation to PCM Holding BV and PCM Uitgevers BV (together, PCM), the publisher of a number of Dutch quality newspapers, that may affect how leveraged buyouts (LBO) of Dutch target companies will be structured and the way such companies will need to be managed, both during and after an LBO.

Lessons to be learned from the PCM decision

Although one should interpret the PCM decision against its rather exceptional factual backdrop (high leverage, odd shareholder structure, very inconsistent management and supervision, industry (newspapers) having an important community function etc), we believe that there are a few more general lessons to be drawn from this decision that may be relevant to the private equity sector.

Importance of balancing the interests and safeguarding the objectives and the strategy of the target company in an LBO

As an LBO leads to considerable financial commitments for the target company, all those involved in the decision-making process of the target company in relation to the LBO must balance the intended and reasonably expected advantages for the target company of the LBO against any disadvantages. They must also make sure that any objectives and strategies that the

target company wants to attain with the LBO and in light of the target's more general future strategy are sufficiently safeguarded.

Private equity sponsor must also observe interests and objectives and strategies of the target company

The Dutch legal principles of reasonableness and fairness require a private equity sponsor, in its capacity as a future shareholder, when acting to become a shareholder of a target company to take into account not only its own interests but also those of the target company, including the objectives and the strategies that the target company wants to attain with the LBO.

It is interesting to note in this connection that although the Enterprise Chamber on the one hand decided to extend the principles of reasonableness and fairness to a future equity investor, it was on the other hand relatively mild in its discussion of the early exit (because of strained relationships) of the private equity sponsor in this case, Apax, for an exit price that was perceived to be very high.

Deciding whether an LBO (or a particular proposed purchaser) is in the target company's interests is the primary responsibility of the target company's management

Deciding whether the LBO is in the target company's interests is the primary responsibility of the management board (and the supervisory board, if any) of the target company. The fact that a proposed purchaser may pay a higher price (important to the selling shareholder)

Mismanagement

Dutch law provides for an inquiry by the Enterprise Chamber into the affairs of a Dutch company at the request of certain interested parties to look into possible mismanagement.

The term 'mismanagement' (*wanbeleid*) is not defined by law. Mismanagement is not limited to the management by the managing directors but can relate to acts by supervisory directors, shareholders or others within a company, as well. Mismanagement refers to a condition of a company. It includes the inadequate functioning of the company as a legal entity. The Enterprise Chamber has held that 'to act contrary to elementary principles of running an enterprise in a sound manner' constitutes mismanagement.

If an inquiry is ordered, the Enterprise Chamber will appoint investigators to perform it. The Enterprise Chamber will determine on the basis of the facts as set out in the report whether mismanagement has taken place. Any opinion expressed by the investigators in their report is not binding on the Enterprise Chamber.

Following the acquisition by Apax in May 2004 of a controlling stake in PCM, and the subsequent disposal of that stake in March 2007, the labour unions requested an inquiry by the Enterprise Chamber into the affairs of PCM. After a very critical investigators' report, the Enterprise Chamber has now decided that there was mismanagement by PCM from 1 January 2004 to 2 July 2007.

The investigators' report and the judgment by the Enterprise Chamber that mismanagement has taken place may serve as a factual basis for other proceedings – eg against the managing directors or supervisory directors personally. However, separate proceedings are required before the competent court can establish whether the facts and findings of the Enterprise Chamber – to the extent not rebutted – are sufficient grounds for a managing director or supervisory director to be held personally liable.

There is the possibility of appeal against the Enterprise Chamber's decision to the Supreme Court of the Netherlands. This court would not conduct another full review of the case, but would merely assess whether the Enterprise Chamber has correctly applied Dutch law. It is not yet clear whether an appeal will be sought against the PCM decision.

may not always be the decisive factor when determining whether that purchaser will be selected, particularly if the LBO by that proposed purchaser will not, or will no longer, serve the interests of the target company, including the objectives and the strategies that it wants to achieve with the LBO.

The Enterprise Chamber's findings in this decision were probably heavily influenced by the specific circumstances of this case. PCM's management and supervisory boards failed to properly balance the advantages of the LBO

against its disadvantages. The original strategy of the boards to pursue an LBO (it would bring in the funds needed to diversify the target company's business) had become much more difficult to achieve by the time the LBO was to be effected, but the boards nonetheless continued to support the LBO process without any proper further analysis of whether an LBO, or the proposed purchaser, was still in PCM's interests. In fact, according to the Enterprise Chamber, the only reason the PCM boards in the end still appear to have supported the LBO was that it would lead to the replacement of the existing majority shareholder.

Furthermore, the boards had failed to safeguard an enforceable commitment on the part of the private equity sponsor to provide the funds needed for the diversification of the business, which also contributed to the court's finding of mismanagement. In this connection, the Enterprise Chamber also pointed out that the stated strategy for the PCM business of the remaining bidders in the LBO process had been that of growth of the newspaper business rather than diversification of the business.

Management participation schemes are subject to more scrutiny

The Enterprise Chamber identifies several issues with respect to management participation schemes that are agreed as part of an LBO:

- the risk of conflicts of interest, in which the private interests of management as investors prevail over the long-term interests of the target company, including the specific function of that company in the community (in this case as a publisher of quality newspapers);
- the risk of conflicts of interest may be increased by such things as unreasonably high envy-factors and the fact that the future proceeds for management depend on the level of the exit price rather than the underlying performance of the target company or the personal performance of the relevant members of management; and
- the negative effect management participation schemes may have on personal and business relations and the perceived integrity of management within the target company.

Depending on the circumstances of the case (including the type of business the target company is in and its function in the community), these risks and effects of management participation schemes must be addressed by the corporate bodies of the target company (particularly the supervisory board, if any) and may even lead them to the conclusion that a proposed management participation scheme cannot be implemented, at least not in the form that may initially be proposed by a private equity sponsor.

Conclusion

It should be expected that some of the standards set out in the PCM decision are going to play a role in structuring new LBOs and in managing existing portfolio companies in the Netherlands.

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