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Non-Competition Covenants: Seller Considerations and Approaches[1]

By Mason H. Drake

Introduction

The benefits of selling closely held businesses range from the receipt of cash or stock and increased diversification of one's assets, to the simplification of family relationships. But such benefits normally come burdened with certain restrictive covenants in favor of the buyer of a business, the principal one generally referred to as a "non-compete."

A non-compete usually consists of more than one specific covenant, each of which may overlap with the others, but which together are designed to preserve the buyer's "benefit of the bargain" of acquiring an asset that will not, for a certain period following the closing, be diminished in value due to certain actions of the seller. For instance, if you sell me your automotive parts manufacturing company, I will want you to promise to me that the day (or, indeed, some number of years) after the closing, you will not open up another similar manufacturing company across the road (or, moreover, within the same county or state, or even country).

Unreasonably broad in scope, geographically far-reaching or long covenants not to compete may not be enforced—or may be narrowed in their application—by courts. The general standard of reasonableness is whether such covenants protect a buyer's legitimate business interests and are suitably limited by time and geographic area. But the ultimate determination of the enforceability of non-competes varies from state to state in the United States, and

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certainly by country, and therefore the limited scope of this article does not seek to address the myriad nuances of local interpretation.

As a general matter, sellers need to be comfortable that they can abide by the following aspects of non-competition covenants: 1) the definition of a competitive business or enterprise, 2) the duration of the covenant, 3) the geographic scope of the covenant, 4) restrictions affecting the seller's ongoing relationships with (a) customers and (b) employees of the acquired entity, and 5) limitations on the use of presumed confidential information of the acquired entity and, by extension at times, of the buyer. A well-represented seller will carefully define and limit each of the foregoing in the definitive transaction documents.

Defining What Constitutes a "Competitive Business" or "Competitive Activity"

In the first instance, one needs to assess what would constitute "competition" that would violate the promise not to compete given by a seller to the buyer. A seller should be wary of agreeing to refrain from "any" type of activity conducted by a buyer, and certainly not from any activity that is not currently conducted by a buyer but in which the buyer happens to engage in in the future. Typically, it is wise to limit the definition of "competitive activity" or "business" to the type of business that is conducted by the seller (or the target being sold) as of the date of closing. It would be possible to expand this definition to include any business actively being pursued by the seller pursuant to written plans and board approval, but generally it is best to be as specific as possible regarding the definition of "competitive business" or "competitive activity" and relate it back to the precise type of assets, operations and business conducted by a seller at closing. It is the business of the seller as conducted at closing that should be the subject of the non-compete, not a generic reference to the business of the buyer and its affiliates; for it is the seller's business that is being purchased and the buyer only has a legitimate business interest in restricting a seller from that particular activity.

The Temporal Length of the Non-Competition Restriction

The sale of a business will typically involve a request from the purchaser for a time period of between three to five years during which the prohibited activity may not be conducted by a seller. However, it is possible in certain cases to have no pure non-compete at all—subject normally to compliance with non-solicitation covenants and confidentiality restrictions discussed below. Anything more than five years would be highly unusual (and difficult to enforce)—provided that, as discussed below, a confidentiality restriction could theoretically be unlimited in time. A nuance to the term of a non-compete is the consequence of a violation and whether the term is "tolled" or extended during the period of such a breach, thereby increasing the length of the covenant. In the interest of certainty, sellers should resist such a remedy and push for a fixed period of the covenant while permitting the buyer to resort to attempting to prove actual money damages as its remedy for a breach in lieu of specific performance (which would extend the restrictive period by the period during which there was a breach).

The Geographic Scope of the Non-Competition Restriction

In this digital and interconnected era where many businesses are global and virtual in structure, the geographic scope of the non-compete covenant can sometimes be difficult to come to terms with, because any limitation at all sometimes seems to a buyer as inadequate protection. However, for many types of businesses (such as those that manufacture and ship tangible assets) it is possible to formulate a realistic range of miles from the selling business's current locations within which a seller cannot engage in the competitive activity, particularly if, for example, shipping of the product becomes expensive

outside of that range. For other businesses (e.g., those that engage in e-commerce) that can easily be performed anywhere in the world, a more global restrictive area may be appropriate.

Non-Solicitation Restrictions with Respect to Employees, Vendors and Customers

Along with a straight non-compete agreement, and even in the rare instance that a non-compete is not included in a sale transaction, buyers usually insist on restrictions that limit a seller's ability after the sale to interfere with the employees, vendors and/or customers of the acquired business.

The restriction on soliciting or hiring employees is extremely common as the employees are a critical asset of most businesses and buyers do not want to have their human capital plundered post-sale by a seller with whom the employees of the target may have worked well and even developed friendships. Usually this restriction will run the same period as the non-compete (although for pure employees not constituting sellers of a business the non-solicit is typically two years or less). A seller should resist a flat prohibition on "hiring" any person (as opposed to actively soliciting a person for hire) as individual employees should be free to work for whomever they want so long as the seller has not initiated contact with them. In addition, employee non-solicits commonly permit hiring in response to general advertisements. Sometimes the employee non-solicitation covenant can be limited to specific key individuals, which is useful in a sale of a large enterprise.

The restrictions on soliciting or working with customers (and sometimes vendors) of the target is more controversial from a seller's perspective, because the type of activity prohibited should, for a seller, tie back to the definition of the non-compete rather than preclude all interaction with those customers. A seller may have wide-ranging relationships with a variety of persons and companies and should be free to continue to engage in business with all such parties so long as the seller is not diverting business related to the assets purchased away from the buyer. In other words, so long as a seller is not intentionally interfering with a buyer's business and the assets purchased, a seller can legitimately argue that they should be free to act as they please. This is particularly true of vendors, and a seller should resist any restrictions on activities with prior vendors to its business.

Of course employees, vendors and customers of a business are all critical assets, but a seller should carefully articulate the types of interaction with such parties that should be prohibited. Frequently this narrowing is most successful in the context of interactions with customers because the buyer does not have a legitimate business interest in restricting a seller's activity with such parties unless it would compromise the specific business it has purchased.

Confidentiality Issues

Another vast store of value in many companies is intellectual property—whether registered patents, trademarks or copyrights or applications for the same, or general trade secrets and "know how." Most definitive purchase and sale documents include a covenant of the seller that it will not use or disclose the confidential information of the target business being sold. This covenant often has no time limit associated with it. A seller should carefully review the confidentiality provisions to ensure that they cannot be used as a stealthy non-compete that would restrict business activities indefinitely. It is best to be specific about the nature of what is truly confidential, limit it to information concerning the business being sold (as opposed to general information of the buyer unrelated to the business being sold), and exclude information in the public domain or generally known in an industry. Other common exceptions to the definition of confidential information include independently developed products or concepts, or

information that is subsequently obtained from third parties not bound by a confidentiality agreement with the buyer.

Valuing the Non-Compete

Certain transactions will involve a specific allocation of the purchase price to the non-competition agreement. Sellers should consult with their tax advisors as to the impact of such an allocation for tax purposes, as it could shift a portion of the goodwill being purchased into a non-compete payment and therefore possibly a different and less advantageous tax rate for the seller. An allocation of a specific portion of the purchase price to a non-compete could, for example, result in such portion of the purchase price being taxed at ordinary income rates rather than capital gain, and therefore should be avoided by a seller.

Sellers could consider asking for additional specific consideration outside the purchase price in connection with the non-compete, which would clarify the foregoing issue. This is particularly appropriate if not all sellers of a business are subject to the non-compete (for instance, many investment funds that are owners of a business being sold will not agree to be subject to a non-compete, whereas the founder of such business is frequently so burdened disproportionately). Frequently, a consulting agreement will be provided to a founder-type seller for periods following closing of a transaction that provides some of this additional compensation.

Conclusion

The non-competition covenants related to the sale of a business are complex and involve multiple layers of restriction. A seller must carefully separate and narrow the various aspects of these restrictions, and will be successful in this effort if the seller is able to convince the buyer that it is still receiving the benefit of its bargain with respect to protection of the asset purchased while permitting the seller to engage in general business activity. Good communication between a seller and its lawyer will assist in making sure that the transaction documents are thoughtfully drafted to capture the expectations of a seller going forward after a sale. Being more, rather than less, specific is, in the context of non-competes, almost always in a seller's best interests.

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[1] An earlier version of this article was published in the Fall 2013 edition of *SRR Journal*, a publication of Stout Risius Ross.

Make Sure to Sign on the Dotted Line – A Delaware Limited Liability Company and its Members are Bound by the Company's Limited Liability Company Agreement, Whether or Not They Sign the Agreement

By Kenneth A. Gerasimovich and Jennifer Brady

The express wording of Section 101(7) of the Delaware Limited Liability Company Act (the LLC Act) provides that a "limited liability company is bound by its limited liability company agreement whether or not the limited liability company executes the limited liability company agreement."[1] The Delaware Court of Chancery recently applied Section 101(7) of the LLC Act in *Seaport Village Ltd. v. Seaport Village Operating Company, LLC*[2] (Seaport), finding that a limited liability company could enforce the fee shifting provision of its limited liability company agreement, even though the company was not a party to the agreement.

The Seaport Decision

In *Seaport*, Seaport Village Operating Company, LLC (Seaport LLC) sought to recover attorneys' fees and expenses pursuant to a fee shifting provision of its limited liability company agreement that allowed the prevailing party in an action "brought by any party against another party" to recover reasonable attorney's fees, costs and expenses incurred in the prosecution or defense of such action.[3] Seaport Village Ltd. argued that because Seaport LLC had not signed its limited liability company agreement, it was not a "party" to the agreement and therefore could not recover its fees and expenses pursuant to the agreement.[4] The Chancery Court was unpersuaded by the argument, finding that the defense failed as a matter of law.[5] The Court summarized the statutory history of Section 101(7) of the LLC Act, which was amended in 2002 to codify case law holding that the limited liability company agreement of a Delaware limited liability company was binding on the company and its members, whether or not signed by the company.[6]

Implications of the Seaport Decision and Section 101(7) for Members of Delaware Limited Liability Companies

The *Seaport* decision is not surprising given the unambiguous language of the LLC Act. Section 101(7), however, contains provisions that reach beyond the question at issue in Seaport. As the Chancery Court pointed out in *Seaport*, Section 101(7) was further amended in 2005 to clarify that members also are bound by the limited liability company agreement, whether or not they execute the agreement.[7] Section 101(7) provides that a limited liability company agreement may be any agreement, *written, oral or implied*, of the members as to the affairs of a limited liability company and the conduct of its business. It also states that a written limited liability company agreement may provide that an assignee of membership interest may become a party to the limited liability company agreement without executing the agreement, if the assignee complies with the conditions of becoming a member as set forth in the limited liability company agreement or any other writing.

Seaport highlights the critical importance of setting out the terms that will govern the limited liability company and its members in a written agreement that is signed by all members and the company, and revisiting the agreement anytime membership interest is issued or assigned. Members who begin

operating a limited liability company based on a loose set of oral understandings while they work out the details of a written agreement may find they are bound by an ambiguous and unwritten operating agreement. Likewise, an assignee of a membership interest may be bound by the company's existing operating agreement, including capital call provisions, transfer restrictions and limitations on management rights, even if the assignee never signs the agreement.

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[1] The full text of Section 101(7) of the LLC Act, which defines limited liability company agreement, reads as follows: "'Limited liability company agreement' means any agreement (whether referred to as a limited liability company agreement, operating agreement or otherwise), written, oral or implied, of the member or members as to the affairs of a limited liability company and the conduct of its business. A member or manager of a limited liability company or an assignee of a limited liability company interest is bound by the limited liability company agreement whether or not the member or manager or assignee executes the limited liability company agreement. A limited liability company is not required to execute its limited liability company agreement. A limited liability company is bound by its limited liability company agreement whether or not the limited liability company executes the limited liability company agreement. A limited liability company agreement of a limited liability company having only 1 member shall not be unenforceable by reason of there being only 1 person who is a party to the limited liability company agreement. A limited liability company agreement is not subject to any statute of frauds (including Section 2714 of this title). A limited liability company agreement may provide rights to any person, including a person who is not a party to the limited liability company agreement, to the extent set forth therein. A written limited liability company agreement or another written agreement or writing: a. May provide that a person shall be admitted as a member of a limited liability company, or shall become an assignee of a limited liability company interest or other rights or powers of a member to the extent assigned: 1. If such person (or a representative authorized by such person orally, in writing or by other action such as payment for a limited liability company interest) executes the limited liability company agreement or any other writing evidencing the intent of such person to become a member or assignee; or 2. Without such execution, if such person (or a representative authorized by such person orally, in writing or by other action such as payment for a limited liability company interest) complies with the conditions for becoming a member or assignee as set forth in the limited liability company agreement or any other writing; and b. Shall not be unenforceable by reason of its not having been signed by a person being admitted as a member or becoming an assignee as provided in paragraph (7)a. of this section, or by reason of its having been signed by a representative as provided in this chapter."

[2] *Seaport Village Ltd. v. Seaport Village Operating Company, LLC*, 2014 WL 4782817 (Del. Ch. Sept. 24, 2014).

[3] *Id.* at 1-2.

[4] *Id.* at 2.

[5] *Id.*

[6] *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 287 (Del. 1999).

[7] *Seaport*, 2014 WL 4782817 at 3.

The Nature and Extent of European Union Sanctions Against Russia and Ukraine

By Adam Cain

This article seeks to focus on the restrictions imposed by the European Union (the EU) on investors with economic interests in Russia and Ukraine or who are engaging in transactions involving entities with such interests. It is clear that there are issues emanating as a consequence of the current export license and sanctions regime that the EU has decided to introduce. There have been, and it is likely that there will be further, Russian measures affecting Ukraine in response to the sanctions regime imposed by the EU.

The Crimean referendum on March 16, 2014, in which the head of the referendum election commission stated that 96.8 percent of voters supported secession from Ukraine marked a key date in the deterioration of the relationship between the two countries, given that steps have now been taken in both Crimea and by the Russian government to effectively annex Crimea to enable it to become a constituent part of the Russian Federation. As a direct consequence of this decision, a series of EU Regulations have been adopted targeting trade with Crimea and Sevastopol, which is explored in greater detail below.

Travel Bans for Individuals and Asset Freezing for Certain Entities and Individuals

In response to the annexation of Crimea and Sevastopol, the EU Council adopted a series of Regulations which were targeted at senior politicians and governmental officials in Ukraine that were deemed to be responsible for the misappropriation of certain Ukrainian state funds. EU Council Regulation 284/2014 was adopted on March 21, 2014, and this expanded the list of sanctioned persons. A number of the EU Regulations that were adopted in March 2014 were focused on travel bans and asset freezes on governmental officials such as the previous president of Ukraine, Viktor Yanukovych, and his sons, and certain Russian military and governmental officials that were considered to be closely linked to the ongoing conflict in Ukraine.

Those individuals and entities that are subject to the asset freezing regime and a travel ban as applicable were named in Annex I to EU Council Regulation 269/2014, which has been supplemented incrementally by additional Regulations including EU Council Regulation 959/2014 adopted Sept. 12, 2014. As of 28 November, there were 23 entities and 119 people that were subject to the restrictions set out in Annex 1 of EU Council Regulation 269/2014. Pursuant to the EU Foreign Affairs Council meeting of 17 November, the EU announced that 13 individuals and five entities involved in separatist activities against Ukraine's territorial integrity would be designated with effect from 29 November. EU Council Regulation 1270/2014 contains the details of those individuals and entities.

The EU Regulations require the freezing of all funds and economic resources belonging to or owned, held or controlled by a sanctioned person, and they prevent EU-incorporated companies and EU citizens from “making funds or economic resources available, directly or indirectly,” to or for the benefit of a sanctioned person. These Regulations therefore significantly impair the ability of EU companies and citizens to engage in business activities with those persons that are subject to the sanctions regime and individuals and corporate entities that are associated with them. The EU sanctions effectively prohibit transactions that touch upon the funds or economic resources of sanctioned persons or which permit them to be used in any way.

The above mentioned restrictive measures are directly applicable and are therefore binding on the member states of the EU. They apply within the territory of the EU to any person inside or outside the territory of the EU who is a national of a member state, to any legal entity, body or person, inside or outside the territory of the EU which is incorporated or constituted under the law of a member state, and to any legal entity, body or person in respect of any business done in whole or in part within the EU. Member states also have the ability to issue their own guidance as to the way in which the sanctions imposed by the EU are to be interpreted as well as detailing any steps that businesses are expected to undertake in order to ensure compliance with the panoply of Regulations. In the United Kingdom, Parliament enacted SI 2014/507, The Ukraine (European Union Financial Sanctions) Regulations in March 2014 to ensure the adequate enforcement of the EU sanctions.

Commentators have reported that companies and individuals that are trying to act in compliance with the EU sanctions may experience problems in terms of being able to identify whether a sanctioned person either controls or in fact owns an entity. The question as to whether a sanctioned person has a controlling interest in a business is not entirely clear cut, and member states of the EU can adopt different rules of interpretation to determine this. In the UK, guidance has been issued by HM Treasury which states that questions in respect of “control” or “ownership” of an entity will be reviewed on an individual basis. When determining this fact, companies or individuals should consider whether the sanctioned person can exercise dominant influence and they should also take into account the underlying management structure that the business is subject to. As to the question of ownership, the EU has provided helpful guidance which suggests that a sanctioned person is presumed to own a business if that person has an interest of 50 percent or greater in it.

Sector Specific Sanctions

On July 31, 2014, EU Council Regulation No. 833/2014 was adopted which set out an array of targeted, sector specific sanctions aimed at certain elements of Russian economic activity. The measures adopted by the EU on this date were groundbreaking in that they imposed sanctions for the first time in areas as diverse as oil-related technologies and the financial sector. The EU regime and that which has been adopted by the United States are similar but not entirely the same. Different banks have, for instance, been the subject of sanctions in the United States and the EU.

The increased hostilities within Eastern Ukraine during August 2014 resulted in the Council of the European Union adopting new restrictive measures targeting Russian companies and individuals, which were published in the Official Journal of the European Union on Sept. 12, 2014. They seek, amongst other things, to restrict Russia’s access to the capital markets of the EU and place a particular emphasis on finance, energy and defense activities, three key elements of the Russian economy. These measures may be strengthened, repealed or suspended at short notice. Indeed, a review of the ongoing ceasefire at the end of September 2014 by the EU adjudged that Ukraine’s current peace deal is not fully effective. Extensive press coverage of the current sanctions regime indicates that EU leaders are divided as to whether to strengthen economic sanctions against Russia. Commentators expect this issue to be discussed extensively at the next European Union summit in mid-December.

These new measures adopted in September 2014 are intended to expand and strengthen the scope of the earlier sanctions approved by the EU in late July which limit access to EU capital markets for Russian state-owned financial institutions and certain other Russian companies and their non-EU subsidiaries. EU Council Regulation 960/2014 that was adopted Sept. 8, 2014, stipulates that EU-incorporated companies and EU citizens are prohibited from purchasing, selling or otherwise dealing in bonds and other

securitized debt and money-market instruments with a maturity exceeding 30 days which have been issued by Russian-controlled defense companies, Russian-controlled energy companies and Russian-controlled credit institutions. A full list of the companies that are the subject to these sanctions is set out in EU Council Regulation 960/2014. In addition, any financial services related to such transactions are prohibited.

The sanctions regime has also been expanded to prohibit EU-incorporated companies and EU citizens from having any direct or indirect involvement in the provision of loans or credit with a maturity exceeding 30 days after Sept. 12, 2014, to the companies and banks set out in EU Council Regulation 960/2014. The provision of loans that have a specific and documented objective to provide emergency funding to meet liquidity and solvency requirements for subsidiaries within the EU that are majority owned by the state-owned banks and that are expressly identified in EU Council Regulation 833/2014 are carved out from this restriction. The provision of credit or any loans that have a specific objective of providing financing for non-prohibited imports or exports of goods and non-financial services between the EU and Russia are also excluded from the scope of this new prohibition. It is important to note, however, that these new measures are crucially not targeted at gas production and export companies, which are considered critical to European energy supplies.

It is also prohibited to supply, export, transfer or sell military equipment to Russia or for use in Russia, or to purchase any such equipment from Russia, or to provide any related technical services or financial assistance. There is also a broad prohibition on the export of dual-use equipment and technologies to the Russian entities identified in EU Council Regulation 960/2014. The provision of any related financial or technical assistance in respect of dual-use equipment and technologies to any of the Russian entities set out in EU Council Regulation 960/2014 is also expressly prohibited.

Sanctions Relating to Trade with Crimea and Sevastopol

On June 25, 2014, EU Council Regulation 692/2014 came into force which prohibits the import of goods originating from Crimea or Sevastopol into the EU. The ban also extends to the direct or indirect provision of financing or financial assistance, as well as reinsurance and insurance services related to these goods. It is important to note, however, that these prohibitions do not apply to those goods originating in Crimea or Sevastopol which have been made available to the Ukrainian authorities for examination, for which compliance with the conditions conferring entitlement to preferential origin has been verified in accordance with the relevant EU Regulations, or in accordance with the EU-Ukraine Association Agreement, which was signed by EU heads of state and government and Ukrainian President Petro Poroshenko on June 27, 2014.

How Can a Business or an Individual Make a Challenge to the Sanctions Regime and are There Recent Examples of This?

A person that is named as being subject to the sanctions regime would be able to challenge any decision by the EU Council in the European Court of Justice headquartered in Luxembourg.

There are recent examples of challenges to the sanctions regime, as the large, privately-owned Iranian bank, Bank Mellat, managed to successfully challenge its status as a designated person under the EU and UK sanctions against Iran in 2013. The challenge was brought on procedural as well as substantive grounds, although the courts recognized that governments should be given a wide margin of appreciation when deciding upon whom to impose sanctions.

The Outlook in the Region

It is clear that the ongoing crisis in the region is having very far-reaching consequences, causing a great deal of commercial disruption and affecting a wide array of investment portfolios. On a practical note, prudent businesses should take steps to minimize potential commercial and political risks in order to protect their existing positions, and parties should pay particular attention to their contractual obligations and dealings with counterparties in the region to avoid unwittingly contravening the sanctions regime.

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European Union Guidelines on State Aid for Rescuing and Restructuring Non-Financial Undertakings in Difficulty

By Professor Claudio Biscaretti di Ruffia and Ada Villa

Introduction: the New Guidelines in the Context of the State Aid Modernization Program

The European Commission (the Commission) has recently completed the review process of its guidelines on assessing Member States' support measures to rescue and restructure companies in difficulty[1]. The review of the rescue and restructuring guidelines is a key element of the Commission's State aid modernization program, which is part of a more comprehensive coordination of national economic policies to achieve the common objective of continued, inclusive and sustainable growth of Member States and to rationalize their public spending.

In furtherance of this effort, on May 8, 2012, the Commission adopted a Communication on State aid modernization[2], setting out an ambitious State aid reform program aimed at three main goals, as follows.

First, the Commission proposal seeks to identify common principles needed for assessing the compatibility of aid with the internal market. State aid control shall support sustainable growth of the Member States and contribute to improving the quality of public spending by discouraging aid that does not bring real added value and distorts competition. To this purpose, the Commission has revised and streamlined some existing State aid guidelines, including guidelines for the rescue and restructuring of firms, to make such texts consistent with those common principles[3].

Second, the Commission wants to strengthen its enforcement activities with respect to the most significant cases relating to the internal market, in order to obtain a deeper ex ante scrutiny of large and potentially distortive aid, as well as perform enquiries by sector across Member States.

Finally, the Commission intends to streamline the rules to allow a faster decision-making process in the field of State aid. In particular, regulations have to be revised; the notion of State aid needs to be clarified, and the Procedural Regulation has to be modernized with regard to complaint-handling and to introduce market information tools and sector enquiries in State aid.

Genesis of Rescue and Restructuring State Aid Guidelines

On July 9, 2014, the Commission adopted the new guidelines on State aid for rescuing and restructuring firms in difficulty (the New Guidelines) after a consultation on draft guidelines launched Nov. 5, 2013. The New Guidelines, entered into force Aug. 1, 2014, will apply until Dec. 31, 2020, replacing a set of rules on rescue and restructuring of companies that have been in force since the 1990's.

In fact, the original guidelines on the subject matter were adopted by the Commission in 1994[4]. In 1999, the Commission issued an amended version of the guidelines[5]. Then, in 2004, a further version of the guidelines followed[6].

The revision of the 2004 guidelines, which were originally due to expire in 2009, was postponed a number of times[7] as a result of the financial crisis, during which the Commission applied a special rescue and restructuring regime for the financial sector[8]. The initial idea consisted of adopting new rescue and restructuring rules applicable to both the financial sector and the real economy. In the end, the New Guidelines only apply to non-financial firms in difficulty.

However, the New Guidelines drew on all of that work, as well as on the basis of the Commission's experience in applying the pre-existing rules and in assessing rescue and restructuring aid for banks during the crisis. As a consequence, the Commission has considerably tightened the conditions under which rescue and restructuring aid may be approved under the New Guidelines.

Basic Principles of the New Guidelines

The New Guidelines define the criteria for Member States, in line with EU State aid rules, for granting public funding to companies in financial difficulty.

Specifically, in the New Guidelines the Commission sets out the conditions under which State aid for rescuing and restructuring non-financial undertakings in difficulty may be considered to be compatible with the internal market, on the basis of Article 107(3)(c) of the Treaty on the Functioning of the European Union (TFEU)[9].

First of all, it must be pointed out that in the New Guidelines some key principles of the 2004 guidelines remained unchanged. In particular, the New Guidelines confirm the so-called "rescue aid" to companies undergoing financial difficulties, to allow them to stay in business for long enough to prepare a restructuring plan. Rescue aid may be granted temporarily for a maximum duration of six months[10].

Beyond such period either the aid must be reimbursed or a detailed restructuring plan must be notified to the Commission for the aid to be approved as "restructuring aid." Restructuring aid aims at supporting a firm's restructuring and it can be granted for a longer period, but only once over a period of ten years, to prevent companies that are not viable from being kept artificially alive through public support. The plan must ensure that:

(i) The long-term viability of the company is restored without further State support;

(ii) The distortions of competition induced by the State support are addressed by specific and adequate measures[11] to minimize them; and

(iii) The company contributes to the costs of restructuring, bearing a sufficient proportion of the costs of its restructuring.

Key Novelties Introduced in the New Guidelines

The guidelines of 2004 focused mainly on ensuring that when aid was granted measures were taken to minimize distortions of competition, whereas the New Guidelines include "filters" designed to check that aid is truly in the public interest to avoid the useless waste of taxpayers' money.

First, Member States must demonstrate that the aid is necessary to pursue an objective of common interest, such as the need to prevent hardship or address market failures[12]. Second, Member States have to present a comparison with a credible alternative scenario not involving State aid[13].

In addition, the New Guidelines introduce a new concept of temporary restructuring support for small and medium enterprises (SMEs)[14], specifically designed to simplify the granting of State funding for restructuring, while reducing distortions of competition by favoring measures that are less distortive, such as loans and guarantees, over structural aid, such as direct grants or capital injections.

This is a change from the 2004 guidelines under which all forms of restructuring aid were treated alike[15] and, as noted above, rescue aid could be granted temporarily for a period of up to six months, giving the company the necessary time to prepare a restructuring plan. Beyond this period, the aid either would have to be reimbursed or a restructuring plan notified to the Commission for the aid to be approved as restructuring aid.

Now, SMEs that need such support can obtain it on the basis of a simplified restructuring plan for a maximum of 18 months. Up to six months of that support can be in the form of rescue aid, which simply needs to meet certain basic conditions[16]. After the end of the six-month period, the recipient of such support must submit a simplified restructuring plan to continue to receive temporary restructuring support. In the simplified plan, the recipient must explain how the aid is intended to be used to achieve long-term viability, but it is not required to provide information on its own contribution or measures to limit distortions of competition[17].

Among the useful concepts and clarifications contained in the New Guidelines, is the simplification concerning "undertakings in difficulty." This definition has been significantly simplified in comparison to the 2004 guidelines by removing any subjective elements and replacing them with objective criteria linked to financial ratios to assess the health of a company[18].

Finally, to ensure that aid is used to maintain viable economic activity and jobs and not to bail out shareholders, the Commission has refined the concept of "burden sharing."[19] The New Guidelines require that the stakeholders[20] of companies that receive aid contribute to the costs of restructuring. Specifically, company investors will be primarily responsible for covering incurred losses before any State aid is granted and the State[21] will receive a fair share of any future gains if the restructuring plan succeeds. With respect to the nature of the contribution, the New Guidelines also now require that the company's own contribution be similar to that of the State aid[22]. As a result, taxpayers' costs are reduced and the company may obtain a better outcome by ensuring that private investors are committed to its future.

Practical Implications and Conclusions

The main practical implication of the New Guidelines consists of making it more difficult for companies to be eligible for rescue and restructuring aid and to comply with the compatibility criteria for Commission approval.

However, it is worth mentioning that, in exceptional cases, to simplify the process of granting small amounts of aid to companies in difficulty, the New Guidelines allow Member States to set up aid schemes. Once a scheme has been approved by the Commission, grants of aid to individual companies do not need to be authorized in advance, provided they meet the conditions of the scheme. The New Guidelines make clear that schemes are the best way to grant aid to SMEs.

The New Guidelines apply to all non-financial firms, except to those operating in the steel or coal sector and without prejudice to specific rules concerning undertakings in difficulty in particular sectors[23]. The Commission also will apply the New Guidelines to the fisheries and aquaculture sector, as well as to the agriculture sector, including the primary agricultural production sector[24].

The Commission will make aid assessments under the New Guidelines with respect to notifications regarding companies in difficulty made after Aug. 1, 2014. All notifications made before such date will be assessed under the 2004 rules, even if the Commission reaches a decision after the date that the New Guidelines entered into force.

Finally, the Member States will have now a six-month time limit to bring any existing rescue and restructuring aid schemes into compliance with the New Guidelines.

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[1] Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty, OJ C 249, 31.7.2014, p. 1 ff. For more general information regarding the next changes in the State aid rules, see SANTA MARIA, *European Economic Law*, 3rd Ed., Kluwer Law International, 2014, p. 470 ff.

[2] Communication from the Commission – EU State Aid Modernization, COM (2012) 209 final.

[3] See, in particular, Regional Aid Guidelines, adopted June 19, 2013; Research & Development & Innovation Framework, adopted May 21, 2014; Draft Commission Guidelines for State aid in the agriculture and forestry sector and in rural areas 2014 to 2020 and New draft Block Exemption Regulation for the agriculture and forestry sector and for rural areas; Environmental and Energy aid Guidelines, adopted April 9, 2014; Communication from the Commission concerning the Criteria for the analysis of the compatibility with the internal Market of State aid to promote the execution of important projects of Common European interests, published June 20, 2014; Risk Finance Guidelines, adopted Jan. 15, 2014; Broadband Guidelines, adopted on Dec. 18, 2012; Aviation Guidelines, adopted Feb. 20, 2014.

[4] Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 368, 23.12.1994, p. 12. On this matter see BISCARETTI DI RUFFIA, *State Aid and Insolvency Proceedings*, in SANTA MARIA (Ed.), *Competition and State Aid. An Analysis of the EC Practice*, Kluwer Law International, 2007, p. 123 ff.

[5] Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 288, 9.10.1999, p. 2.

[6] Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 244, 1.10.2004, p. 2.

[7] First, until Oct. 9, 2012, (see Commission Communication concerning the prolongation of the Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 156, 9.07.2009, p. 3) and subsequently, until their replacement by new ones (see IP/12/1042 and Commission communication concerning the prolongation of the application of the Community guidelines on State aid for rescuing and restructuring firms in difficulty of Oct. 1, 2004, OJ C 296, 2.10.2012, p. 3), in order to

avoid pre-empting the discussions on State aid modernization (see IP/12/458 and the Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on EU State aid modernization program of May 8, 2012, COM(2012) 209 final).

[8] The revision also takes into account either the "Europe 2020 strategy" adopted by the Commission (Communication from the Commission: EUROPE 2020 - A strategy for smart, sustainable and inclusive growth, COM(2010) 2020 final) and the fact that the negative effects of State aid might interfere with the need to boost productivity and growth, preserve equal opportunities for undertakings and combat national protectionism.

[9] For a criticism of the extensive application of Article 107 TFEU by the Commission in respect of State aid schemes, see SANTA MARIA, *European*, cit., p. 470 ff.

[10] See BISCARETTI DI RUFFIA, *State Aid*, cit., p. 124.

[11] Such as asset sale or capacity reductions.

[12] The New Guidelines provide for a non-exhaustive list of situations in which aid would be justified under the cited provision: for example in areas of high unemployment where the granting of restructuring aid will reduce the scale of job losses; or where the failure of the firm would lead to irremediable loss of technical know-how.

[13] This requirement does not apply to rescue aid or temporary restructuring support.

[14] For a definition of small and medium-sized enterprises (SMEs) and an overview on State aid to SMEs, see LANDI, *Exemptions from the General Incompatibility Principle under Article 87(2) and (3) of the EC Treaty*, in SANTA MARIA (Ed.), *Competition and State Aid*, cit., p. 63-68.

[15] No differences, indeed, were provided among loans, guarantees, debt waivers, capital injections and even outright cash grants.

[16] For example, conditions concerning the minimum interest rate.

[17] This information, instead, is required to be contained in the detailed restructuring plan.

[18] For instance, among the added criteria there are those used to evaluate whether the company burden of debt is sustainable and whether it generates enough profits to cover its interest payments.

[19] This concept was developed during the financial crisis, when burden sharing became necessary to protect the interests of taxpayers and consumers where large amounts of public money were made available to banks, and is now extended to apply to non-financial firms.

[20] Including subordinated creditors.

[21] Hence taxpayers.

[22] For example, if the State grants capital, the company must also contribute through an equity injection.

[23] See Community Guidelines on State aid for railway undertakings, OJ C 184, 22.07.2008, p. 13.

[24] "Primary agricultural production" means production of products of the soil and of stock farming, without performing any further operation changing the nature of such products.

Private Equity: Cross-Border Acquisition Structures in the Line of Fire?

By Graham Iversen

Proposed Changes to International Tax Rules Could Have a Major Impact on Private Equity Structures

In a discussion document published Nov. 21, 2014, the Organisation for Economic Co-operation and Development (the OECD) has acknowledged an issue which has been causing increasing concern in the international private equity community.

As many readers will know, the OECD has been asked by the G20 Governments to develop a plan for reframing the international tax system. This is the so-called "Base Erosion and Profit Shifting" project (BEPS). The BEPS project has arisen from concerns amongst governments and tax authorities that the international tax system has not kept pace with the development of international business and capital

structures. Public outcry and media attention (whether or not well-informed) about the tax affairs of some high profile corporations has pushed this work towards the top of the international political agenda.

One of the action plans which the OECD has been developing is a plan to counter “Treaty Abuse” – i.e. transactions and business structures which (in the OECD’s view) unfairly allow taxpayers to claim relief from taxes under international tax treaties.

A key proposal in this area is that countries participating in the BEPS project should be encouraged to amend their tax treaties to include a “limitation on benefits” provision (an LoB). The United States generally seeks to include LoB provisions in its tax treaties and has done so for some years, but very few other countries in the world follow that practice. In particular, LoB provisions are very rare in tax treaties within Europe.

The OECD’s LoB proposal would essentially prevent a taxpayer from claiming benefits under a tax treaty unless the taxpayer satisfies one of a number of conditions, the main conditions being that:

> the taxpayer’s shares (or other ownership interests) must be listed and actively traded on a recognized stock exchange; or

> the taxpayer must carry on an active trade or business in the country in which it is tax resident.

Impact on Private Equity

This is an important issue for private equity investors and fund managers, because it is common for acquisition and holding vehicles used in European private equity acquisition structures to claim benefits under tax treaties, particularly to avoid the imposition of withholding taxes on interest and dividend flows.

A large number of these kinds of acquisition and holding vehicles will fail to qualify for treaty benefits under the LoB provision currently proposed by the OECD, because:

> typically, neither the acquisition or holding vehicle nor the private equity fund that ultimately owns it will be listed or actively traded on a recognized stock exchange; and

> the acquisition or holding vehicle will normally be holding investments, rather than carrying on an active trade or business (the holding or managing of investments is specifically excluded from the concept of an active trade or business under the OECD’s current proposals).

The result would be that many European private equity structures would suffer a significantly higher tax burden, resulting in reduced post-tax returns for investors. Fund managers would need to consider whether those tax costs could be mitigated through restructurings (see further below).

Representations about this issue have been made to the OECD by a number of private equity representative bodies and fund managers.

The OECD has now at least acknowledged publicly that this important concern has been raised by the private equity sector. However, the OECD’s discussion document published on 21 November 2014 does not propose any solutions for private equity. It merely invites comments on whether there is indeed a problem for private equity here and how to address those concerns without creating opportunities for treaty abuse.

The OECD has previously suggested some ways in which the LoB proposal could be amended to address the position of "mainstream" investment funds (i.e. widely-held funds including retail funds). Most of those suggestions revolve around asking fund managers to determine the treaty entitlements of their investors. Those proposals remain under discussion with the "mainstream" funds sector, but if applied to the private equity sector they would present severe practical problems for most private equity funds, who generally have no straightforward means of establishing the treaty entitlements of their investors. The problem is particularly acute in "fund of funds" cases, where private equity funds may effectively have to look through higher tier fund structures, possibly tracing through to thousands of ultimate investors.

Restructurings?

Private equity fund managers may wish to consider possible restructuring steps which could mitigate the impact of the BEPS proposals. For example, restructurings might enable holding or acquisition vehicles to rely on domestic exemptions from withholding taxes, rather than claiming treaty benefits.

The outcome of the OECD's action plan could ultimately incentivize funds to undertake more fundamental restructurings – for example, to divide into funds of treaty eligible investors and non-treaty eligible investors and to allocate investments in high tax jurisdictions to the former where possible – but most funds will no doubt wish to wait until there is greater clarity about the outcome of the BEPS proposals before undertaking such a restructuring.

Fund Documents

In any event, general partners and fund managers may wish to consider including provisions in new fund documentation, and amending existing fund documentation, to assist fund managers in the onerous task of obtaining information from investors about their treaty entitlements, in case that effectively becomes necessary as a result of the OECD's action plan.

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View from Amsterdam: EU Competition Law Compliance – An Altered Legal Landscape

*By Hans E. Urlus, Emilie van Hasselt, Teresa Charatjan, and Jacomijn Christ**

EU competition law prohibits the restriction of competition by agreements between competitors that may affect trade between Member States and have as their object or effect the restriction of competition (Article 101 TFEU). An agreement will fall outside this prohibition if it is not capable of appreciably restricting competition or trade between Member States. This *de minimis* principle was established by the European Court of Justice (ECJ) in 1969, *inVölk v Vervaecke*, where the ECJ held that *"…an agreement shall fall outside the prohibition when it has only an insignificant effect on the market, taking into account the weak position which the persons concerned have on the market of the product in question."*[1] In order to offer guidance on how to interpret the *de minimis* principle as established by the ECJ, the European

Commission (the Commission) periodically has issued a Notice, outlining that the Commission will not start proceedings in cases which fall below the thresholds set out in the *De Minimis* Notice.

The most recent *de minimis* Notice, issued in 2001 was, due to developments in ECJ case law, revised again this summer. The Commission clearly stated in the notice that, even if the market share thresholds are not reached, a restriction "by object" is nevertheless assumed to appreciably restrict competition and therefore does not fall within the *De Minimis* Notice safety zone. This appears to follow the 2012 ECJ Expedia ruling, in which the ECJ emphasized that *"an agreement that may affect trade between Member States and that has an anti-competitive object constitutes, by its nature and independently of any concrete effect that it may have, an appreciable restriction on competition."*[2] The revised *De Minimis* Notice supported this view.[3]

On Sept. 11, 2014, however, the ECJ drastically altered the legal landscape with its judgment in *Groupement des Cartes Bancaires*,[4] which clarified the application of "by object" restrictions, focusing on its 2013 *Allianz Hungária*[5] ruling rather than, as the Commission had done, on the earlier ECJ *Expedia* ruling. The facts of the ECJ's *Groupement des Cartes Bancaires* decision merit discussion.

Facts

The *Groupement des Cartes Bancaires* (CB) – an economic interest grouping – was created in 1984 in France so that holders of a CB-card issued by a member of CB could make payments to affiliated traders, and/or make withdrawals from automatic teller machines operated by members. In 2002, CB adopted three pricing measures: (i) a fee payable by a CB member whose CB-card issuing activity exceeded its activity in affiliating new traders to the system; (ii) a reform of the membership fee for new members, which consisted in a fixed sum and a supplementary membership fee for members whose number of CB-cards in stock exceeded a certain threshold at a given moment; and (iii) a fee per CB-card issued, payable by "dormant" members (those who were inactive or not very active before the date of entry into force of the new pricing measures). As required, CB notified the Commission of these new measures.

After two statements of objections from the Commission, CB submitted offers of commitments which the Commission found to be out of time and inadequate. Subsequently, the Commission declared that the association shut out new entrants from the market for issuance of payment cards in France. According to the Commission, the measures were applied in such a way as to hinder the issuing of cards by smaller banks prepared to offer cards at lower prices. The Commission concluded that the measures were anti-competitive both by object and by effect, and therefore breached article 101 of the Treaty on the Functioning of the European Union (TFEU).

CB appealed the decision, but the General Court (GC) dismissed the appeal holding that the CB pricing measures constituted a "by object" restriction of competition, and therefore that the effects of the measures did not have to be considered. CB appealed to the ECJ, arguing that the GC should not have considered the measures to be a restriction of competition by object.

The ECJ Ruling

The ECJ emphasized that "by object" restrictions comprise certain types of coordination between competitors that reveal such a significant degree of harm to competition that there is no need to examine their effects — similar to the U.S. rule of *per se* illegality. The ECJ stressed, however, that under settled case-law, in order to determine whether an agreement between competitors, or a decision by an association of competitors, reveals a sufficient degree of harm to competition to constitute a restriction of competition 'by object' within the meaning of Article 101 TFEU, regard must be had to: (i) the content

of the agreement's provisions, (ii) its objectives, and (iii) the economic and legal context of which it forms a part. In making this determination, it is also necessary to consider the nature of the goods or services affected, and the real conditions of the functioning and structure of the market or markets in question. All of this sounds very much like a rule of reason evaluation.

The ECJ determined that the GC should have applied this standard when it examined whether the CB's activities caused a sufficient degree of harm to competition to constitute a "by object" restriction. The ECJ added that even though the parties' intentions are not a necessary factor in determining whether an agreement is restrictive "by-object," as noted above, there must be consideration of the content of its provisions, its objectives, the economic and legal context of which it forms part, and the nature of the goods of services affected. The ECJ annulled the GC's judgment, declaring that the GC had failed to properly apply the essential criteria.

Analysis

The CB judgment was a rather strongly worded statement by the ECJ, and contains a cautionary message to the Commission and all national authorities and courts relying on *Expedia*. According to the ECJ, the concept of restriction of competition "by object" can be applied only to certain types of coordination between undertakings which reveal a sufficient degree of harm to competition that there is no need to examine their effects. The ECJ's CB judgment clarifies three important notions:

(i) an alleged restriction "by object" is to be examined on the basis of its objectives and in its economic and legal context ;

(ii) the fact that an agreement simply has the potential to restrict competition is not enough to qualify it as a restriction "by object," and therefore if the type of coordination between undertakings does not reveal a sufficient degree of harm to competition, the Commission should examine its likely effects on competition; and

(iii) a restriction "by object" can only be found with respect to coordination that "reveals a sufficient degree of harm to competition."

These notions imply that the ECJ favors an extensive and almost full judicial review of the Commission's competition decisions, and also requires the Commission to apply a more detailed assessment of the arguments of the parties and the relevant factors before concluding that a restraint harms competition in such a way that it should be qualified to be a restriction "by object," as meant by article 101 TFEU.

The Impact of the CB Decision

A similar approach as in *Cartes Bancaires* was taken on the same day as the ECJ decision by Advocate-General Wahl (AG Wahl), in his opinion in *FNV Kunsten Informatie en Media v. Staat der Nederlanden*. He considered whether a collective labor agreement between associations of employers and associations of employees, pursuant to which self-employed persons perform the same work as employees of a company, fell outside article 101 TFEU, because the provision was contained in a collective labor agreement. AG Wahl took the view that "the fact that a contractual provision in a collective agreement lays down minimum tariffs for self-employed persons in competition with workers for the same job is not in itself enough to bring those provisions within the scope of the antitrust rules."[6] The advocate general advocated a more cautious approach in this assessment, in line with the ruling of the ECJ in CB.

The same view possibly had already been considered by Advocate-General Kokott in para. 43 of her opinion in the 2012 Expedia ruling, when she stated: *"Consequently the national competition authorities and courts are free to proceed against agreements between undertakings below the thresholds of the* de minimis *notice, provided that they have taken due account of the Commission's guidance in the notice and that, in the particular case, there is evidence, other than the market shares of the undertakings concerned, which suggests that the effect on competition is appreciable."*

There is a reason for applying a rule of reason to alleged restrictions "by object." Parties should not be sanctioned for intending to restrict competition when they are unable to do so.

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**Not admitted to the practice of law.*

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[1] Case 5/69 *Völk v Vervaecke* [1969] ECR 295, paras. 5-7.
[2] Case C-226/11 *Expedia* December 13, 2012, para. 37.
[3] See also *GT Alert,* "ECJ eliminates Noticeability Test in Regard to Restriction of Competition by Object" of January 2013 by Hans Urlus and Sanne Mulder, and "HvJ EU Expedia en de mededingingsrechtelijke merkbaarheid, Gevolgen voor de Nederlandse praktijk," *Markt & Mededinging*, Aug. 1, 2013.
[4] Case C-67/13 P *Groupement des cartes bancaires* Sept. 11, 2014.
[5] Case C-32/11, *Allianz Hungária a.o./Gazdasagi Versenyhivatalon* March 14, 2013.
[6] Opinion of Advocate-General Wahl at Case C-413/13 *FNV Kunsten Informatie en Media v. Staat der Nederlanden* Sept. 11, 2014 para. 99.

View from China: Shanghai Announces Regulations on the Shanghai Pilot Free Trade

By George Qi and Dawn Zhang

On July 25, 2014, the Stand Committee of Shanghai People's Congress published the *Regulations on China (Shanghai) Pilot Free Trade Zone* (the Regulations), just before the first anniversary of the debut of the Shanghai Pilot Free Trade Zone (the FTZ). The Regulations went into effect August 1, 2014.

The Regulations introduce several reforms and principles that will be implemented in the FTZ, including reforms in the areas of foreign investment, outbound investment, international trade, financial services and foreign exchange.

Foreign Investment and Outbound Investment

The Regulations state the principle that in the FTZ restrictions on investments (including investor qualification requirements, limitations on foreign shareholding percentage and limitations on business scope) in the areas including financial, shipping, trading, professional, culture and social services will be suspended, relaxed or eliminated.

Further, the FTZ will implement the "Negative List" model with respect to the supervision of foreign investments. Foreign investments in industries outside of those stated on the Negative List will only be subject to record-filing requirements, instead of being subject to governmental approval.

With respect to outbound investments, the Regulations state the principle that investors in the FTZ may engage in multiple forms of outbound investments, and that in principle outbound investments, will only be subject to record-filing requirements.

International Trade

With respect to international trade, the Regulations provide different levels of regulatory control depending on the areas between which the trade occurs. Trading activities between the FTZ and areas outside of China are referred to as "front-line" trades, and trading activities between the FTZ and other parts of China are referred to as "second-line" trades. The Regulations state the regulatory principle of "opening up for the front-line, safe and efficient control of the second-line and free flow within the FTZ."

The Regulations also state certain concrete international trade measures to be implemented in the FTZ, including (but not limited to):

- The establishment of a Customs supervision system based on the status of goods that will be managed based on an electronic network;
- Paperless clearance with low-risk, high-speed release;
- The customs declaration procedure can be done after the goods to be imported are shipped into the FTZ; and
- No time limitation will be imposed on goods under bonded warehousing in the FTZ.

Financial Services

With respect to financial services, the Regulations state the general principle that, under the assumption that the risks are controllable, the FTZ will gradually implement RMB conversion for capital items, the marketization of financial market interest rates, cross-border use of RMB and foreign exchange reforms.

The Regulations provide that a free trade account system will be set up in the FTZ. Residents and non-residents in the FTZ may open free trade accounts. Funds between free trade accounts and between a free trade account and an overseas account can be freely transferred. Cross-border financings and guarantees can be conducted under free trade accounts in accordance with relevant regulations.

The Regulations also provide that the foreign exchange process for cross-border direct investments will be simplified.

Other Areas

In addition to the above, the Regulations have provisions relating to merger control, tax collection, immigration matters and other comprehensive supervision measures to facilitate business in the FTZ. The Regulations also encourage professional service firms, such as accounting firms, law firms and intellectual property agent firms, to develop business opportunities in the FTZ.

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- The Regulations on China (Shanghai) Pilot Free Trade Zone
- Issuing authority: the Stand Committee of Shanghai People's Congress
- Date of issuance: July 25, 2014 / Effective date: August 1, 2014

View from Italy: Crowdfunding in Italy

By Ada Villa

Introduction

Crowdfunding is an emerging alternative source of financing involving open invitations to the public, generally via the internet, to finance a project through a donation, a monetary contribution in exchange for a reward, product pre-ordering, lending or investment. Any type of project can launch a crowdfunding campaign: SMEs, artists, innovative start-ups and social entrepreneurs may all benefit from different forms of crowdfunding.

The legislation concerning this new kind of funding has been amended recently by the Italian Government through several recent reforms aimed at facilitating access (particularly, for start-ups) to alternative forms of (micro)financing. Crowdfunding is playing a key role in the current economic climate, providing an alternative to ever more tightening bank credit during the present crunch scenario[1].

Legal Framework

Among the provisions contained in the Growth Decree *bis*[2], which entered into force Oct. 20, 2012, when the Italian Parliament issued and published its implementing law[3], are new measures for the incorporation and development of innovative start-up companies, including equity crowdfunding.

The law was preceded by the presentation and publication of the "Restart, Italia!" report, drafted by the task force of the Minister of Economic Development, and equity crowdfunding was finally allowed by Consob (i.e. *Commissione Nazionale per le Società e la Borsa*, the Italian authority on financial markets), which issued the Regulation No. 18592 of June 26, 2013, for the collection of risk capital by innovative start-ups via online portals.

Basically, pursuant to Article 30 of the Growth Decree *bis*, interests held in innovative start-up companies incorporated as limited liability companies can be bid in the context of a public offer of financial

products, including through online fundraising portals. This rule represents an exception to the provision under Article 2468, first paragraph, of the Italian Civil Code, pursuant to which (i.e. *società a responsabilità limitata – S.r.l.*) stakeholders' interests in a limited liability company cannot be represented by shares or offered in a public offering of financial products.

On the one hand, this exception, which applies to riskier start-up companies, is interesting from the perspective of growing new companies, which generally are incorporated as limited liability companies, as well as the development of Italy's capital markets. On the other hand, however, it calls into question the reasons behind the prohibitions under the Italian Civil Code that restrict limited liability companies in general from offering equity interests.

In addition, Article 30 of the Growth Decree *bis* has amended the Italian Financial Code[4] (i) inserting the definition of "portal for the collection of capital for the innovative start-ups" (intended as an online platform having as its exclusive scope the streamlining of fundraising for innovative start-ups) and (ii) stating that the management of such portals is limited to investment firms, banks authorized to provide related investment services and entities enrolled in a special register kept by Consob (*i.e.* Register of portal managers), which must send orders for subscriptions and acquisitions of financial instruments representing corporate capital to banks and investment companies exclusively.

In order to enroll in Consob's Register of portal managers, entities other than banks and investment firms must meet the following requirements:

The registered entity must be formed as a joint stock company, limited partnership, limited liability company or cooperative company;

(i) It must be registered or have an administrative office in the Italian Republic, or, for European community entities, a stable organization in the territory of the Italian Republic;

(ii) It must have as its corporate purpose the professional management of portals for fundraising for the innovative start-ups;

(iii) Consob's requirements of honorability applicable to controlling entities and entities performing administrative, directing and supervising activities must be satisfied; and

(iv) Consob's requirements of professionalism applicable to entities performing administrative, directing and supervising activities must be complied with.

Furthermore, the Growth Decree *bis* introduced the new Article 100-*ter* of the Italian Financial Code, titled "Offers trough portals for the collection of capital", pursuant to which public offers for subscriptions of financial instruments issued by innovative start-ups may be carried out exclusively through one or more fundraising portals. The consideration for such subscriptions must be lower than an amount determined by Consob.[5]

Recently Consob has adopted rules applicable to such offers, which are aimed at ensuring that professional investors or particular categories of investors subscribe for a portion the offered financial instruments and at protecting investors, other than professional clients, in the event that the controlling stakeholders of innovative start-ups transfer their interests to third parties after an offer.

Crowdfunding Cases in Italy

Crowdfunding, as a relatively new form of finance, has slowly become established in Europe[6] and two years following the publication of the relevant regulations in Italy various portals have been authorized. As of today, each of the first three portals registered with Consob, Unicaseed[7], StarsUp[8] and Assiteca Crowd[9], has successfully closed its first offering, raising, all together, over one million euros.

The first proposal, which was successfully funded through Unicaseed, was by Diaman Tech, a financial software company that closed its capital raise on March 30, 2014, receiving 157,780 euros in three months covering 107.3 percent of the target. Seventy-eight investors invested in the offering, three of which were institutional investors with subscriptions totaling 19,600 euros (13.3 percent of the total offering). Consob regulations require, as a mandatory condition for closing, that at least 5 percent of the investment is subscribed for by a professional investor. The minimum investment in the Diaman Tech offering was 490 euros and the maximum was 11,000 euros.

The second proposal, which was funded through StarsUp, was by Cantieri di Savona for a project to develop a low emission boat. It raised 380,000 euros in six months (from Jan. 28, 2014, to July 21, 2014) from 44 investors, including the single largest investor who invested 132,000 euros (35 percent of the total). There were 31 investors who invested less than 499 euros – the limit for a single investment established by Consob under the simplified procedure not requiring MiFID profiling[10], representing 70 percent of the investors and less than 4 percent of the total amount raised.

The third proposal, which was funded on Assiteca Crowd, was by Paulownia Social Project, SRF – Short Rotation Forestry, which raised 520,000 euros from only 12 investors, with an average investment from non-professional investors of over 34,000 euros each.

The characteristics of the three offerings described above were quite different:

(i) Diaman Tech raised money mainly in its customer community;

(ii) Cantieri di Savona raised funds mainly from investors from its region (Sardinia); and

(iii) Pauwlonia's offering was structured more like an unsecured loan than an equity investment; in fact the terminal value of the offer is equal to zero and the return for the investors is expected to be a share of profits.

In these first three cases, surprisingly the number of investors was inversely proportional to the total amount raised. This is the first year for Italian equity crowdfunding and we can observe a significant number of initiatives in this area. More than 10 portals have been authorized already, although only a few are active with at least one proposal raising funds. The last quarter of 2014 is seeing an increase in proposals looking for funding and several more platforms joining those currently authorized by Consob.

Creation of a New Market: Equity Crowdfunding

The challenges to creating a viable and healthy market are significant. The first challenge is due to the strong limitations introduced by the legislation and the Consob regulations.

In particular, with respect to the demand side, only "innovative start-ups," as defined by law, are allowed to raise risk capital online. This limitation associates equity crowdfunding with a class of high risk enterprises. There are a limited number of qualified start-ups (2,480 as of today) and a high percentage of start-ups are likely to fail. On the supply side, the regulations limiting investments to less than 500

euros per transaction and less than 1,000 euros per year under the simplified investment procedure (not requiring a MIFID profiling procedure) is artificially compressing the investment amount distribution.

The second challenge, related to the first challenge described above, is the Italian market's propensity for risk and the hurdles this creates in reaching a critical size to sustain at least a few equity crowdfunding platforms.

The current scenario shows an average 5 percent success fee on funding. In order for platforms to reach a total turnover of 2.5 million euros in commissions, a 50 million euro equity crowdfunding market is required. The total venture capital market in Italy is estimated at 100 million euros per year with the Italian Business Angel Network (IBAN) estimating angel investments at 32 million euros in 2013.

Given that the direct financing of private companies and the digital transformation of financial markets are long-term solid trends, it will take years and hopefully progressive European legislation to obtain a shake out and a transformation of equity crowdfunding platforms.

In conclusion, the new provisions are aimed at facilitating the transition from an e-commerce generation to an e-investing generation. Equity crowdfunding has a long way to go, but considering that next year Italy will host the Global Entrepreneurship Congress and EXPO in Milan, 2015 will be an important year in the history of equity crowdfunding.

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[1] Another new form of financing recently implemented by Italian Governments is that concerning mini-bonds. For references, see L. SANTA MARIA and A. VILLA, *A View from Italy: New Italian Private Corporate Debt Rules - Opportunities for Foreign Investors*, in The GT M&A Report, Vol. 6, Ed. 1, June 2014.
[2] Law Decree No. 179 del 18 October 2012 - Further Urgent Measures for the Growth of the State ("*Ulteriori misure urgenti per la crescita del Paese*") known as Growth Decree *bis*.
[3] Law No. 221 of Dec. 17, 2012, published on the Official Gazette No. 245 of Oct. 19, 2012 –Ordinary Appendix No. 194.
[4] Legislative Decree, Feb. 24, 1998, No. 58 as subsequently amended.
[5] As demonstrated by data showing that in Europe funds amounting to about one billion euros in 2013 were collected.
[6] As demonstrated by data showing that in Europe funds amounting to about one billion euros in 2013 were collected.
[7] See http://www.unicaseed.it
[8] See http://www.starsup.it
[9] See http://www.assitecacrowd.com
[10] The Markets in Financial Instruments Directive 2004/39/EC (MiFID), as subsequently amended, has formalized the need for financial firms to get to know their customers. Specifically, the MiFID requires financial operators to investigate the suitability and appropriateness of a product or service to a client, by submitting him or her with a corresponding questionnaire. Depending on the result of the suitability and appropriateness questionnaire, investors can be provided with different services and products according to their needs.

View from London: Completion Accounts Case Law Every Dealmaker Should Know About

By Henrietta Walker and H. Andrew Ross

In the recent case of ***Shafi v Rutherford [2014] EWCA Civ 1186*** *(Shafi)*, the U.K. Court of Appeal was asked to examine an appeal from the High Court regarding the interpretation of a completion accounts

mechanism, a commonly used price adjustment process in company and business acquisitions. The court's decision will likely affect the way in which buyers and sellers describe the mechanism in sale documents and reinforce the importance of financial and legal advisors working closely together.

Completion Accounts: Background

In the sale and purchase of businesses (both share and asset transactions), completion accounts are an often-used mechanism which enable parties to agree the final price payable for the target. A purchaser who strikes a bargain for a business at a certain price can test its assumptions by agreeing with the seller to adjust the consideration paid if those assumptions prove to be incorrect. Completion accounts are commonly used by the buyer to confirm that the financial position of the company or business at completion is consistent with the accounts and other information it used to value the target when making its offer.

After the acquisition is completed, one of the parties draws up the accounts to the date of completion, which allows both parties to evaluate the state of the balance sheet at completion. The parties can then adjust the price paid up or down.

The agreement entered into by the purchaser and seller will set out the method to be used to draw up the completion accounts and how they may adjust the purchase price. Typically, such price adjustments will be based on a target's net assets, or a component part such as working capital, cash and/or debt, and will measure the actual positions at completion against a target by reference to which the purchase price was agreed.

Ideally, in the relevant sale and purchase agreement, the parties will agree the basis of preparation of the accounts, including their form, content and the accounting principles to be used. They will also agree who will draw up the accounts, when and how disputes will be settled and how the price will be adjusted.

As the accounts are not finalized until after the transaction has closed, the parties may agree for the buyer to pay a provisional sum as part of the purchase price to limit any additional amount a buyer may have to pay post-completion or that the seller may have to hand back.

Basis of Preparation

The accounting standards and methodology applied to the accounts do not have to follow any particular policy or any practices previously adopted by the target. There is no legal requirement for the parties to agree to a specific approach; it is largely a question of accounting process and commercial agreement rather than law.

As far as possible, the buyer and its financial advisors should identify matters in the target's audited or management accounts that might lead to disagreements when the completion accounts are drawn up. The accounting treatment of certain items, or the policies used, may contain significant scope for a range of treatment. Ideally, the buyer will want to agree the treatment of these in the terms of the acquisition agreement to avoid disputes.

A seller may be more willing to rely on general statements as to the application of consistent policies previously applied, because it should have a clear idea of what these are. Buyers and sellers will often agree to apply policies and practices in compiling the completion accounts in the following order of priority:

- specifically agreed policies and practices or agreed values in respect of certain items;
- accounting principles and practices adopted by the target in compiling its previous accounts; and
- generally accepted accounting principles and practices under the accounting regime to which the target is subject (such as U.K. GAAP or IFRS).

Although the drafting of a specific agreement will always prevail, it may be said that the generally accepted approach was that the policies and practices described under the third limb, such as U.K. GAAP, would be used to fill the gaps left by the target's past practices under the second limb. The "past practices" of the second limb were typically thought to be those actually adopted and used by the target irrespective of non-compliance with relevant accounting standards. However, in the *Shafi* case, the Court of Appeal cast doubt on this approach.

***Shafi* Case: Background and Decision**

In May 2007, the claimant and defendant formed a company, the Shipley Dental Team Limited (the Company) to establish a dental practice. They each held 50 percent of the shares in the Company, which acquired equipment for the business under leases (the Leases).

On Dec. 17, 2009, the parties entered into an agreement (the Agreement) for the claimant to sell her 50 percent shareholding in the Company (the Shares) to the defendant.

The Agreement contained a completion accounts mechanism to determine the final amount to be paid by the defendant for the Shares. The Company's accountants drew up two sets of completion accounts, but the parties failed to agree them. The parties appointed an independent chartered accountant, in accordance with the Agreement, as an expert to resolve the dispute.

The expert determined that the Leases were improperly treated as operating leases in the Company's accounts for the year ending 2008 (the 2008 Accounts). He found they were in fact finance leases and, if treated as such in the completion accounts, would result in a significant downward price adjustment in respect of the Shares.

The Agreement contained the following provisions governing the preparation of the completion accounts:

> "1.2 The draft completion accounts shall:
>
> 1.3 be prepared in accordance with the specific accounting policies and principles set out in [this Agreement] so that, in the case of any conflict, such policies and principles shall override the provisions of paragraphs 1.4 and 1.5;
>
> 1.4 subject to paragraph 1.3, be prepared in accordance with the accounting policies, principles, practices and procedures adopted by the Company in the preparation of the [2008] Accounts, which include the policies set out in [this Agreement], so that, in the case of any conflict, such policies, principles, practices and procedures shall override the provisions of paragraph 1.5;
>
> 1.5 where none of the accounting policies, principles, practices or procedures referred to in paragraphs 1.3 and 1.4 deal with the matter, be prepared in accordance with generally accepted accounting principles in the U.K. as applicable to small companies as at the Completion Date."

The expert concluded that the policies adopted by the Company described in paragraph 1.4 required him to treat the Leases as operating leases even though such treatment was incorrect under the relevant accounting policies the Company purported to have adopted. This was also the claimant's position, but the High Court ruled that the expert had incorrectly interpreted paragraph 1.4. The claimant appealed.

Decision

In dismissing the claimant's appeal that paragraph 1.4 means the policies, principles, practices and procedures adopted by the Company in fact, and not those which it purported to have adopted, the Court of Appeal upheld the ruling of the High Court:

- the completion accounts should have taken account of the proper treatment of the Leases because they were to be prepared in line with the policies of the 2008 Accounts, which specifically stated they were compiled in accordance with particular accounting standards (in this case, the Financial Reporting Standard for Smaller Entities);
- when clause 1.4 of the Agreement refers to "the accounting policies, principles, practices and procedures adopted in the preparation of the Accounts," it was referring to the policies used by accountants generally and not to the way in which the Company has actually applied those policies; and
- as the 2008 Accounts were expressly stated to be prepared according to a particular policy, the parties cannot have expected the expert to ignore the correct implementation of the policy.

The Court of Appeal further stated that the liabilities of the Company should be drawn up using correct accounting policy regardless of actual past practices and the court could see no reason why the parties would have wished to carry forward an incorrect accounting treatment of liabilities. Instead, the court believed they would have been aiming to reflect the reality of the Company's balance sheet.

The effect of the decision, which is not reported, is presumably that the claimant received far less consideration for the Shares than she had expected. As the 2008 Accounts treated the Leases as operating leases, it seems somewhat unlikely that either party would have anticipated their treatment to be any different in the completion accounts.

The case does not describe whether the buyer had any recourse under warranties in addition to the claim for adjustment pursuant to the closing accounts – in any event a buyer will always prefer a price adjustment to a warranty claim as it provides a far better chance of recovery from the seller and is generally not subject to the same hurdles to recovery such as thresholds and baskets. It is also not clear whether the claimant had any other recourse under the terms of the Agreement in respect of improperly prepared accounts, but given the claimant was the seller in this case, it seems unlikely.

Implications of *Shafi*

The judgment of the Court of Appeal in *Shafi* sets out some important guidance to sellers and buyers considering the completion accounts mechanism within a transaction:

- if the parties want the policies and procedures used in the reference accounts to apply to the completion accounts irrespective of errors, omissions or irregularities in accounting methodology, specific drafting will be required to make this clear;

- if the parties are in doubt as to how an item or policy has been applied in the reference accounts, specific policies to deal with them must be set out in the agreement; and
- as always, financial due diligence and ensuring the principals and legal advisors of both buyers and sellers are involved from an early stage in setting out and negotiating each parties' position are both crucial in any company or business acquisition.

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