OTUS & CO

DUAL LISTED COMPANIES

AN INTRODUCTION

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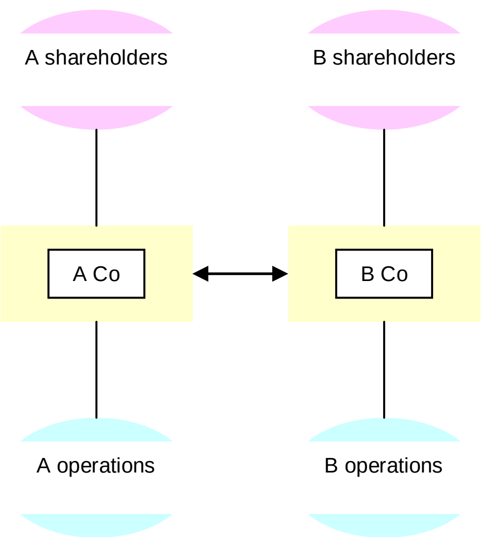
INTRODUCTION

This paper provides a brief overview of the dual listed company structure ("DLC"), sometimes also referred to as a "synthetic" merger.

Simon Read was advisor to Rio Tinto on its merger with CRA of Australia, a DLC merger which created the precedent for all subsequent DLCs.

WHAT IS A DLC?

A DLC is a merger structure which achieves the objectives of a normal, unitary merger but keeps both merging companies intact, each with their own independent stock listings. (It should not be confused with a single company with dual listings).



A DLC is a hybrid structure. It behaves as if it were a single entity most of the time and like two entities some of the time. For example, a DLC behaves just like a normal merger so that all the synergies can be gained and there is one management team and set of board members; however, there remain two separate companies, each with their own stock listings. This flexibility – its "chameleon" nature – is its key advantage; the DLC structure is used where such flexibility is critical to the merger proceeding.

DLCs appear complex and this can be off-putting; however, this needs to be set in context. The vast bulk of the complexity surrounds the legal arrangements to create and administer the DLC, bearing in mind that, as a hybrid structure, DLCs do not readily fit into existing legal, tax and regulatory frameworks. This legal complexity is largely unapparent from outside the merged group; moreover it is largely irrelevant to shareholders and (in most cases) creditors in that their position is as if the merging companies were merged in the normal, unitary manner. In management terms, it is possible to run the business of the merged group as one business, as the management of the existing DLCs now do without reference to the underlying legal structure. Furthermore, it is important to distinguish between the complexities of implementing a DLC, which can be significant, from those of the ongoing administration of a DLC, which are modest; this additional administrative burden (and cost) is borne, typically, by the corporate legal and company secretarial functions without any material impact on operational functions. Complexity is a manageable issue.

HISTORICAL DEVELOPMENT

DLCs are a long-established type of structure, especially in Europe. The first DLC was created in 1907 (Royal Dutch/Shell) and the second in 1930 (Unilever). These two DLCs existed in to modern times, demonstrating the durability of the structure – 100 years in the case of Royal Dutch/Shell.

REUTERS
3 March 2002:
"barriers to the structure are slowly dissolving and 2002 could see the Holy Grail, the first [DLC] between a UK and US corporation"

Although not significant in terms of number, the structure is significant in terms of the scale and corporate profile of the companies that have employed the structure; companies which use or have used the DLC structure include Royal Dutch/Shell, Unilever, ABB, Fortis, Reed Elsevier, Rio Tinto, Zurich Allied/Allied Zurich, BHP Billiton, Investec Carnival/P&O Princess and Thomson Reuters.

FINANCIAL TIMES
28 January 2002:
"Is this the day of the [DLC]?"

The popularity of DLCs has increased significantly in recent decades. From 1907 to 1985 there were only 2 DLCs; in the period since more than 10 have been implemented. As more DLCs have been implemented, the structure has become increasingly recognised and accepted.

breakingviews
"[DLC] merger structures have assumed something of a celebrity status ….. the current zeitgeist of the new millennium"

TWO TYPES OF DLCS

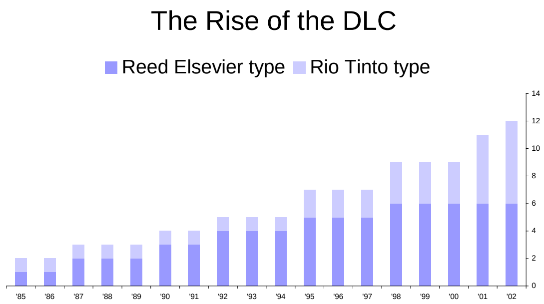
There are two types of DLCs, each with their original antecedents and modern precedents extending as far back as Royal Dutch/Shell and Unilever.

Royal Dutch/Shell (modern precedent Reed/Elsevier) achieves a merger by the simple but very crude expedient of pooling all the assets and operations of the merging entities into one (or more) large joint venture(s) leaving the original parent companies intact as holding companies each owning an interest in the joint venture(s). This has some major disadvantages, in particular the tax implications of moving assets into the joint venture(s).

RIO TINTO

In 1995, Rio Tinto merged with its Australian affiliate and was the first company to adopt the Unilever type of structure since DLCs came back into use in the late 1980s. Rio Tinto incorporated a crucial new improvement into the structure – vote pooling (see below).[1] Since Rio Tinto, all DLCs have followed the Rio Tinto model, including the first with a US-listed company, the Carnival/P&O Princess merger. We believe that, unless circumstances dictate otherwise, the Rio Tinto model is preferable to the Reed Elsevier for several key technical reasons. Furthermore, prior to Rio Tinto, DLCs had been between companies of roughly equal size; in the Rio Tinto case the ratio was 77%/23% and the Rio Tinto structure, unlike the Reed/Elsevier version, is specifically designed to accommodate this imbalance. (There is a cross-holding in the Reed-Elsevier structure, which was deliberately inserted in order to make the two sides 50%/50%, though this device is only relevant when the two parties are quite close to 50%/50% prior to the merger). Furthermore, in theory, the Rio Tinto structure could be used to merge with a new entity, merge three or more entities, or sub-divide an existing entity, as was done in the case of Investec.

[1] Vote pooling was invented by Simon Read, co-founder of Otus, at that time a director of DrKW acting for Rio Tinto



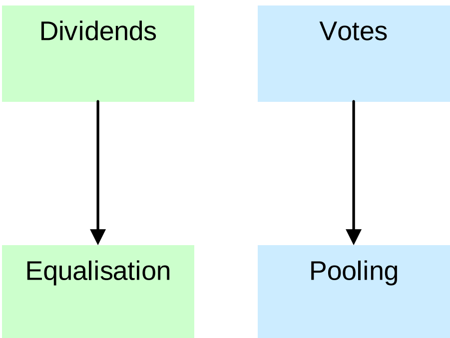
Investec. There is one variant, not further described here, termed an “internal” DLC. This takes an existing company, splits it into two parts, and then merges them back together as a DLC so as to recreate the original entity but with two listed top companies rather than one. This is done in order to access more efficiently pools of capital. It was pioneered in 2001, by Investec, the South African financial services concern which wanted to tap the London listed equity market. Though used for very particular reasons, the principles of the structure are exactly the same as other DLCs – in fact Investec employed the Rio Tinto-type of DLC.

The rest of this paper describes the Rio Tinto model.

THE RIO TINTO-TYPE OF DLC

The overriding objective of the DLC structure is to combine the two merging businesses so that they can be managed as a unified, enlarged operation. To achieve this, the directors need to be able to conduct the affairs of the enlarged business with a view only to the best interests of the entities taken together and without regard to the separate interests of the individual companies. Accordingly, shareholders must be indifferent to the separate interests of the individual companies. Rather than by giving shareholders a single share instrument (as in a normal, unitary merger) in a DLC this is effected by leaving shareholders with their existing share instruments but making those instruments the mirror image of each other – like two sides of a single coin. The alignment of interests of the respective sets of shareholders is achieved synthetically, but the effects are as in a unitary merger. The Unilever/Rio Tinto model is sometimes therefore referred to as a "synthetic" merger or a DLC of the "alignment of interests" type.

The interests of shareholders in a company in virtue of their holding a share comprise two types: the **economic** entitlement to the dividend (both the dividend paid from annual profits and from capital on a winding up) and the **control** entitlement to vote at general meetings. The alignment of interests model of DLC aligns both these aspects of being a shareholder: the alignment of economic interests is termed dividend equalisation, the concept behind the original Unilever model; the alignment of voting is termed vote pooling.



Dividend equalisation ensures that the flow of dividends from the two companies to their shareholders is, forever and including distributions of capital on a winding up, in a ratio which remains fixed (except where adjustments need to be made to accommodate changes in the share capital structure, such as splits). Since the economic interests of the two groups of shareholders are exactly the same, the board is able to manage the assets and operations of the two companies together ***as if they were a single entity***.

Vote pooling ensures that the corporate control of a DLC behaves as if it were a single entity. Because there remain two listed top companies, there are two general meetings; shareholders in each company vote at the meeting of the company in which they hold shares, no differently to ordinary companies and no different to their voting position before the merger. However, in addition, by means of complex legal mechanics, the votes cast by each shareholder group are also cast at the meeting of the other; the result is that the two meetings mirror each other, or that, in effect, only one meeting had taken place – ***as if they were a single entity***.

The effect that is created by dividend equalisation and vote pooling is one that is characteristic of a DLC, and as a rule of thumb if the question arises as to how a DLC behaves the most common answer is – " ***as if it were a single entity***". It is often easier to think of a

DLC as one entity, and then consider the differences that arise from retaining two top companies; and, though this is very much a simplification, one way to think of this is as a single company with two classes of listed share.

Dividend equalisation and vote pooling are the key ingredients in a DLC; the complex legal structures which DLCs employ are designed to bring these two things about. This is primarily done by means of a contract between the two merging companies, together with amendments to the constitutions of the two merging companies.

KEY ISSUES

In our view there are two key issues with a DLC: jurisdictional issues and share price differentials.

Jurisdictional issues. As has been noted, a DLC is a hybrid structure and DLCs are relatively rare and modern. As a result the legal, tax and regulatory frameworks that currently exist largely do not prescribe for this type of corporate entity (unlike, for example, a company or partnership). Furthermore, DLCs are typically used in cross-border mergers; therefore there are two jurisdictions involved.

The first question that needs to be answered in a cross-border DLC is can it be done in the jurisdictions concerned? This is in part answered by precedent. Many of the DLCs involve UK companies; DLCs are now a well-established concept in the UK and the UK jurisdiction is beginning to evolve to specifically accommodate DLCs. DLCs have also involved Australian companies, which have an Anglo-Saxon jurisdictional philosophy. DLCs have also involved Continental European companies – indeed the original two were both Anglo-Dutch, with on the one hand unitary and on the other co-determination board structures.

Of key importance in the evolution of the DLC is in regard to the US jurisdiction. The first relevant precedent, though in the end it pursued the normal unitary model, was BP/Amoco. This merger, it is widely accepted, was going to be implemented by way of a DLC until very late in the process. The DLC was not pursued due to accounting reasons, reasons which, since they involved the application of the pooling of interests concept and merger accounting, are no longer relevant. What is important therefore to learn from BP/Amoco is that the companies accepted that, but for the accounting issue, a DLC would have been feasible. This included accepting certain risks associated with partnership taxation.

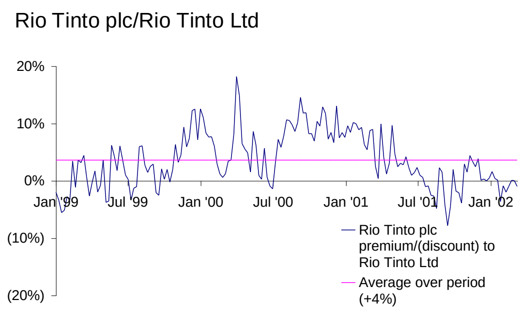
In 2002 Carnival, the cruise ship operator, merged with P&O Princess of the UK. This is a very important precedent for several reasons, but perhaps most importantly because it was the first to involve a US-listed company. This deal established that, in principle, a DLC is possible with a US-listed company. However, Carnival is not a US company; to date there is no precedent of a DLC with a US company.

Finally, the issue of a DLC involving a US company has been investigated very thoroughly even if it has never been implemented, and there is legal opinion of the view that, though the detailed structural arrangements may need to be adapted, a DLC can be implemented with a US company. The partnership taxation issue has been the principal area of concern with regards to a DLC involving a US company. Separate legal opinion would have to be obtained, with specific attention being paid to this area.

Share price differentials. Theoretically the share prices of the two listed companies merged in a DLC should trade in a fixed ratio (as they represent exactly equivalent economic returns from the merged business). In practice, however, this does not occur.

The reasons for this are believed to include: tax differences in the treatment of dividends in the hands of shareholders; currency fluctuations; differences in size/liquidity; indexation effects; market inefficiencies and perceptions.

Analysis of the ratio between the share prices shows that the ratio tends to vary over time; sometimes one share (typically the most liquid) trades consistently at a premium to the other; and the size of the premium/discount, broadly-speaking, tends to range from 5%-15%. For example, the average differential between the two components of Rio Tinto over the three year period to 2002 had been approximately 4%, with the larger (UK) stock trading at a premium for almost the whole of the period, in a band which ranged from roughly -5% to +15%; there was no detectable trend to suggest the ratio was getting wider or smaller over time.



The impact of share price differentials is believed to be felt mainly in terms of share transactions, though it is unclear whether or not this is a significant issue. An examination of the precedents gives some reassurance: shares have been issued for M&A by Rio Tinto, Billiton and Reed Elsevier; shares have been issued by Reed Elsevier and Fortis; and shares have been bought back by Rio Tinto and Royal Dutch. In principle, a DLC offers greater capital raising flexibility than is available to a company with a single share, allowing capital to be raised in either or both of the markets where the two companies are listed – indeed it was to improve its access to capital that Investec pursued the DLC route.

Finally, although the precedents demonstrate the durability of DLCs, and no DLC has been entered into with only a finite life, it should be a relatively modest step, in the absence of prohibiting factors such as nationality requirements, to proceed from a DLC to a normal, unitary structure and so collapse the DLC if this were desired. Moreover, it is reasonable to assume under a DLC structure, as shareholders migrate, the flowback issue is reduced and can be more effectively managed. Allied Zurich is an example of a merger that started as a DLC but was successfully collapsed.

The existence of share price differentials is well known and has not prevented companies from using the structure; it is generally considered to be an acceptable disadvantage of the structure.

REASONS FOR USING A DLC STRUCTURE

DLCs are not common, and very few professionals and managers have direct experience of them. Whilst their familiarity is improving, they are often misunderstood, even among the financial community. This can affect the way in which the DLC is considered by companies when looking at the corporate tools available to them. DLCs should not be dismissed because of their complexity; this, in our view, is a manageable issue except for companies of too small a size. The DLC structure has been refined over the years and there are few disadvantages and these are now well researched; on the other hand a DLC can have very considerable advantages, and in certain circumstances it may be the only available structure. For certain types of merger, such as large cross-border mergers, a DLC should nowadays be considered at an early stage, and not as a last resort.

The reasons for using or considering a DLC usually fall into the following categories:

1. Nationality/regulatory/legal issues

In certain industries, such as the airline and defence industries, the ownership and control of companies is subject to nationality restrictions which would prohibit a unitary merger. DLCs have been considered a potential solution to this issue. Sometimes, as was the case with Rio Tinto, the nationality issue is not a legal one but a political one, and this was a key reason for using the DLC in the case of Rio Tinto.

DLCs are sometimes used to avoid triggering change of control provisions in contracts entered into by the merger parties or in legislation or licences, concessions etc. to which they are subject.. However, care must be taken with the interpretation here; for example, until recently DLCs did not come under the UK Takeover Code because, the argument went, there was no change of control; the Panel recognised that this needed to be changed and has now specifically included DLCs under its Code even though, formally speaking, there is no change of control. Much will depend on the precise wording of the relevant change of control provisions.

2. Flowback

Flowback, where shares issued by one company to shareholders in another country flow back to the country of the issuing company, has been a major concern in, in particular, trans-Atlantic mergers, and a key reason for the renewed interest in DLCs in recent times. Flowback as high as >60% has been recorded and flowback has been blamed for adversely affecting share price performance after the merger. Indeed, a Director-General of the UK Takeover Panel stated that “flowback is the main reason why [DLC] mergers are so popular”.

The scale of flowback that might be expected in a merger does vary – for example, well received mergers tend to suffer less flowback. The difference can be dramatic: the flowback in deals where factors are unfavourable can be double those where favourable factors apply; the relevance of these factors to a particular merger would need to be assessed.

Certain steps can be taken to mitigate flowback, such as lock-ups, though these have had only limited success in the past. On the whole, there is no remedy for flowback in a unitary structure; the only certain way to address flowback is with a DLC - since no shares are issued by either company there are no shares to flow back.

DLCs are therefore seen as attractive, relative to a share exchange, to both parties to the merger: for the offeror, its share price is protected from the adverse effects of flowback; for the offeree’s shareholders, they retain their existing shares, and are not put in the position of having to sell foreign shares received as takeover consideration. This was one of the key reasons cited by P&O Princess as offeree for insisting that Carnival make available a DLC structure as part of that merger.

3. Independence/ corporate governance

In many mergers considerable sensitivity surrounds the loss of independence by the merging party which loses its stock listing. This is also evident in such sometimes thorny issues as corporate name and head office location. A DLC, which retains both the merging companies, can help address these issues.

REUTERS

“The three issues on which many mergers collapse are the **name**, where the [**HQ**] is going to be and who is [**CEO**]. With the [synthetic] merger, both sides can be winners and neither is seen to lose out”

Additionally, there are different corporate governance styles in different regions of the world. In a unitary merger, an unfamiliar structure has to be adopted by one of the merging parties; a DLC allows some greater flexibility in this regard.

4. Strategic financial

For certain very large global businesses a DLC can be attractive in that it allows them to match the sourcing of equity to the demands of the business. These companies are seeking to bridge a perceived gap between the globalisation of business and the globalisation of capital; to the extent that capital is country- or currency- specific and the business is global, it can be attractive to be able efficiently to access equity capital in more than one country and currency.

This is particularly the case for very large companies based in countries with less well developed equity capital markets, or for international companies based in emerging markets.

5. Major shareholders

DLCs have been considered a potential solution for mergers between companies where a large shareholder exists in one (or both) of those companies and such shareholder does not wish to be diluted. This issue often arises in Europe where residual government shareholdings exist in partially privatised companies.

A DLC can offer a solution and it can do this in two ways.

Apparent dilution. In a DLC, there is no change to the shareholder composition of either merging company as a result of the merger. All shareholders retain their existing share instruments in the existing companies. There is no change at the shareholder level; a DLC is implemented by contract between the merging companies.

Consequently, a shareholder with an interest of, say, 30% in one of the merging companies before the merger will have a 30% interest in that company after the merger. There is no apparent dilution.

Substantive dilution. Of course, although there is no apparent dilution, because a DLC is in substance the equivalent of a normal merger, the dilution which occurs in a normal merger can also occur in a DLC.

In a normal merger, between companies of exactly the same size, a 30% shareholder in one company will exchange that 30 % interest in one company for a 15% share of the merged company. Normally a DLC produces exactly the same effect both in terms of economic entitlement and voting. However, in a DLC there is the flexibility to alter, in theory, the flow of economic benefit and, more importantly, the control of the merged group exercised by the shareholders.

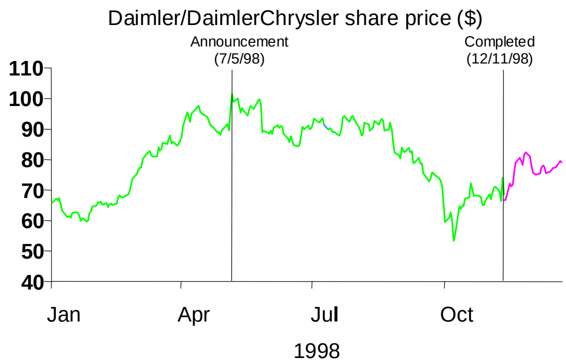
Taking the latter, control, point only, votes in a DLC are normally pooled, the joint voting system described above. However, DLCs preserve the ability to put resolutions to a meeting of one only of the two top companies or to both meetings but without the pooling procedure; these resolutions relate to what are usually termed “class rights” matters. The reasons for this are technical, concerning such matters as adjustments to the equalisation ratio, but having this facility creates the flexibility to extend the list of matters over which one company or both acting separately might have, for example a veto. As a general rule, for commercial reasons, this list should be as short as possible, and normally only includes matters which do not impact on the overall conduct of the group's affairs. However, it remains possible, in principle, to add to the list matters of key significance to one or both sets of shareholders. If this were done, insofar as a shareholder in one company could influence the outcome of a general meeting prior to the merger, so after a DLC merger that shareholder would have exactly similar influence over a meeting called to vote on a resolution put only to that company's shareholders regarding the matter of concern.

In the case of Carnival's merger with P&O Princess, where the Arison family owns some 35% of the combined group, a US-style "poison pill" arrangement was retained by Carnival in the US, even though for the UK company, Carnival PLC, such provisions would have been against UK governance standards. Differences between the US and UK also exist in other areas of corporate governance, and these issues are generally resolved by compromise and discussion with shareholders; in the Rio Tinto case the principle was followed that which ever jurisdiction had the higher standard, that standard would be adopted.

6. Tax

There are in certain jurisdictions tax advantages to a DLC. For example, in the case of Rio Tinto, there were valuable franking credits available to shareholders in Australia that would have been lost in a unitary merger which were preserved because the Australian shareholders continued to receive dividends from an Australian company, without offending Australian rules regarding dividend streaming.

The DLC therefore can resolve various aspects of cross-border mergers which are not capable of being resolved in a unitary merger, and as a consequence, pursuing a unitary merger can be more expensive for the offeror, as the offeree shareholders are offered terms better than they would otherwise have been in order to secure their acceptance. It is in this light – the savings on the financial terms – that the disadvantages of a DLC, for example in a US DLC the potential tax risks, are seen as acceptable.



By way of illustration, commenting on the Daimler merger with Chrysler in 1998, the Financial Times suggested: "The need to persuade Chrysler's shareholders to hold

[Daimler shares] … partly explains why Daimler will end up paying a premium of around 40%."

CONCLUSIONS

In summary, we arrive at the following conclusions:

1. DLC mergers are becoming a well-established technique for large cross-border mergers
2. All the business benefits of a normal merger are generated in a DLC merger
3. The DLC structure is more flexible and successfully resolves certain key issues faced in cross-border mergers
4. The disadvantages of a DLC structure, principally additional complexity, are manageable
5. Jurisdictional issues exist and would need to be investigated fully by relevant experts

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C O N T A C T S

D I R E C T O R S

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