corporate briefing

November 2003

Dual listed company ("DLC") structures – recent developments

Dual listed company combinations have been used to structure cross-border mergers for a long time, Royal Dutch/Shell was created in 1907. In recent years there have been an increasing number of DLC transactions. A DLC structure allows two companies to combine their operations while remaining separate legal entities and, where the companies concerned are from different jurisdictions, this can achieve several advantages over conventional mergers.

When are DLCs considered?

DLCs are rare, and are only used when traditional structures will not work. The set-up costs of DLCs are high and the structures can be complex. The advantages of a DLC may include:

Continuity of domicile

This can be particularly important where a company has a high profile on a national exchange or where nationality may be an issue to investors, regulators or governments. With a DLC structure, two companies can be combined while maintaining their listings on their respective domestic exchanges.

Continuity of corporate identity

Companies may be reluctant to merge by way of takeover because they do not wish to give target shareholders a premium for their shares at the expense of the bidder's shareholders. A DLC can facilitate a nil-premium merger of equals.

Continuity of corporate identity also enables shareholders to continue to invest in structures with which they are familiar and can sometimes be implemented with a lower level of shareholder approval than a takeover.

Continuity of tax treatment

From a shareholder's point of view, it is usually more tax efficient to receive dividends from companies in the same jurisdiction. For example, UK shareholders receive a tax credit on UK dividends which they would not receive on dividends from non-UK companies. A DLC structure can preserve this treatment.

There may also be capital gains tax advantages. As there is no disposal of shares by shareholders roll-over relief will not be required. In addition, certain DLC structures do not involve any disposal of assets by the companies themselves and so do not give rise to a charge at the corporate level.

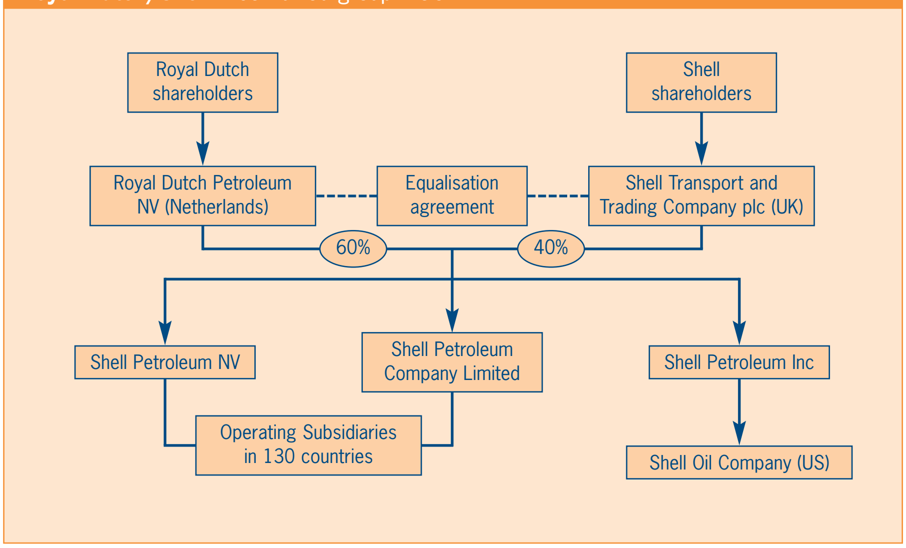
Change of control

In the case of a conventional takeover, the change of control of the target company may trigger termination or pre-emption rights in some of its contracts. Depending on the terms, this issue may not arise with a DLC structure and a DLC may be structured so that there is no change of control. This was a major consideration in the case of the RTZ/CRA transaction as certain mining concessions may have been affected in the event of a change of control. In order to avoid this problem a DLC was used.

Prevention of flow-back

Flow-back occurs in cross-border takeovers/mergers where shareholders are unable or unwilling to hold shares in an overseas bidder. This can arise when funds are only able to hold UK shares or track a FTSE index. The pressure created when such funds sell the target's or bidder's shares can depress the market price. A DLC can relieve this selling pressure, while still enabling operations and management to be combined.

Royal Dutch/Shell – combined group: 1907



Three types of DLC

There are a number of variations on the dual-headed structure. The three main types are:

Combined group

In this structure, the assets and subsidiaries of each top tier company are grouped under one or more jointly owned intermediate holding companies.

The top tier companies typically hold equal (or near equal) voting rights in the intermediate holding companies. The existence of more than one holding company can further assist in the efficient flow of dividends. It may also be that through this structure, the top tier companies are able to retain certain businesses outside of the joint enterprise, by not contributing those assets to the intermediate holding companies.

Royal Dutch/Shell is an example of a DLC using a combined group structure. In this case, shares in the operating subsidiaries of the two companies were held 60-40 by the Dutch and UK arms of the DLC respectively, and an equalisation agreement was entered into between the two top tier companies *(see box 'Royal Dutch/Shell').*

Synthetic

Under this approach, also known as the 'separate entities structure', the two groups remain separate but operate as a single unit by virtue of a series of contractual arrangements. This structure is used in the recent Carnival/P&O Princess combination *(see box 'Carnival/P&O Princess').*

As there is no intermediate holding company there is no transfer of assets.

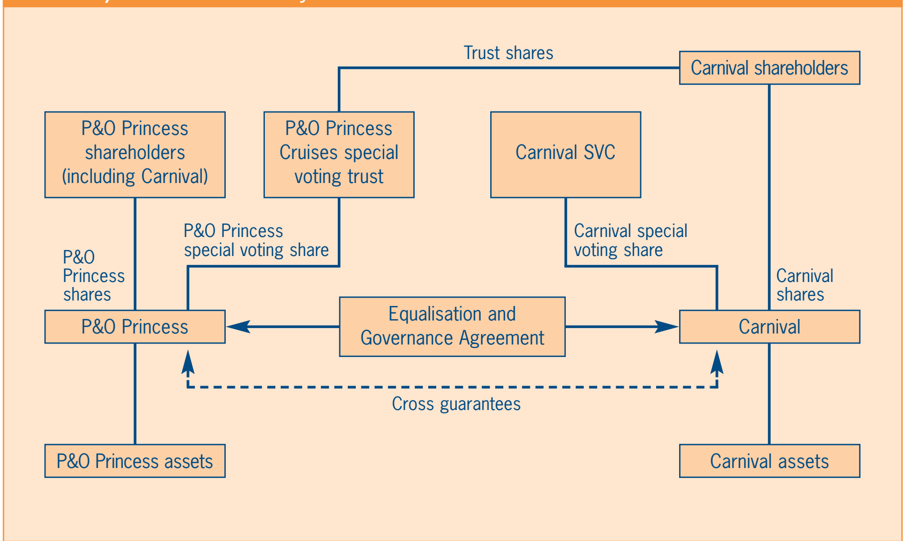
Unity is achieved by means of a sharing agreement between the top tier companies which results in the shareholders of these two companies being treated as if they owned shares in a single entity.

Shareholders receive equalised distributions, and if there are insufficient funds or distributable profits in one top tier company to pay dividends, an equalisation payment or other transfer may be made from the other company so that dividends are matched. If this is not possible, dividends will be limited to the amount which can be paid to all shareholders.

Additional facets of this structure are that:

- there is a free exchange of all financial and commercial information;
- the companies prepare group accounts; and
- there are provisions in each top tier company's articles of association to ensure that the boards of the two companies are identical.

Carnival/P&O Princess – synthetic: 2003



Twinned shares

As in the synthetic structure, there is no intermediate holding company in a DLC structure using twinned shares. Instead, each shareholder holds units that consist of shares in the two top tier companies which are 'twinned' or 'stapled' together (the shares may only be traded in these units).

An advantage of this structure is that, as the shares must trade together, there is no discount or difference between the share price of each company. The danger of shareholders arbitraging the discount is effectively eliminated.

A governing agreement will ensure, amongst other things, unity of share issues, dividends and management. The boards of each company will comprise the same directors.

The twinned shares structure is used by Eurotunnel *(see box 'Eurotunnel').*

Challenges in creating a DLC

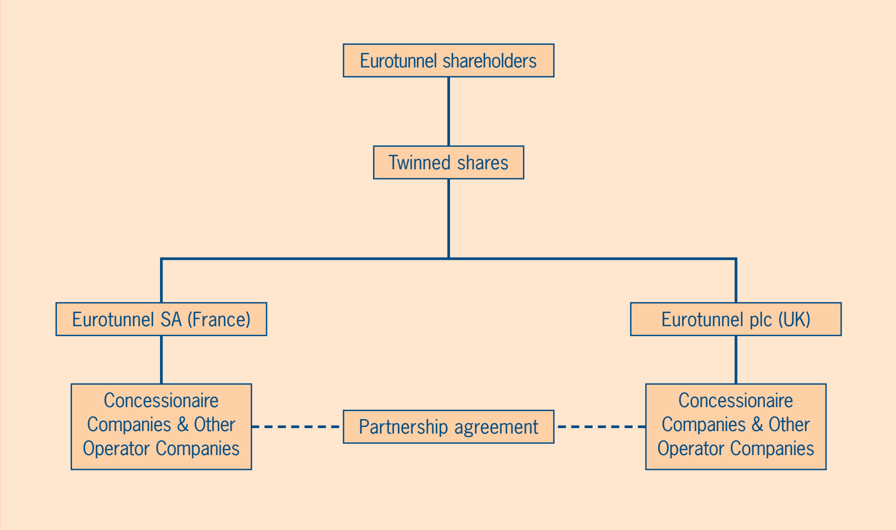
Equalisation

In establishing a DLC, one of the principal challenges is to ensure that there is a mechanism in place so that shareholders in each company have the same economic interest regardless of which company's shares they hold. As such, there will be a mechanism to equalise distributions in each company. This may be pre or post tax. Therefore, if one arm of the DLC performs better than the other, the difference in performance will be equalised for the purpose of distributions.

Voting

Certain matters on which shareholders are entitled to vote may, depending upon the nature of the matter, need to be put to the shareholders of both companies (either voting as shareholders of the separate companies, or as a part of a combined electoral college of both companies). Constitutionally (other than in stapled share structures) this can be difficult to achieve, as it can be difficult to ensure that the votes of one set of shareholders are reflected in the voting of the other set. Special voting shares with variable voting weights and/or

Eurotunnel – twinned shares: 1987



class rights can be used to ensure that on certain matters the shareholders of both companies effectively vote as one body.

Meetings

Practical difficulties can arise in the holding of meetings. It will often be the case that the companies will wish to hold their meetings at the same time in order that, whilst the meetings are technically separate, they appear to be one meeting, with the chairman addressing all shareholders, and voting taking place simultaneously. Given that the companies will be in different jurisdictions, this poses some logistical difficulties: where should the chairman and the other directors be? Can the meetings be video-linked? Each company is also likely to be subject to different company law and regulations governing meetings, voting and levels of shareholder approval which will need to be addressed in the constitutional documents of the two companies to ensure that they operate as a combined group.

Takeovers

A DLC structure can be an obstacle to takeovers, and the share price of the companies may be discounted as a result.

In the case of the synthetic structure and the combined group structure there is a risk that the DLC could be frustrated if a third party acquired one of the companies. In the UK, the Takeover Code prevents a code governed company from putting mechanisms in place that are intended to frustrate a potential takeover without prior approval of the Takeover Panel – for example, mechanisms which would require a bid for one company to be accompanied by a bid for the other.

Regulatory issues

Because each company retains its original listing, the group will have to comply with the regulatory regimes of both jurisdictions – in the case of a DLC including a company incorporated and listed in the UK, this is likely to include the Takeover Code, Listing Rules, Companies Act, and Financial Services and Markets Act. This can reduce the synergies that would usually come from a takeover as the directors will need to ensure that they comply with both regimes and maintain separate head office functions.

Market capitalisation

The different market capitalisations of the companies will usually be reflected in the structure of the DLC in order that control of the group by the shareholders of each company is proportionate to their respective valuations.

Management/directors

Mechanisms will be put in place to ensure that the management of the two companies is identical. Where one company removes a director from its board, there will be a mechanism in place to ensure that that director will be removed from the board of the other company, and vice versa where a director is appointed.

Insolvency

The agreements governing the relationship between the two companies in the group will need to set out what rights the shareholders of each company have in the event of the insolvency of either or both companies. In particular, the way in which distributions are dealt with on a liquidation will need to be carefully thought out.

Debt

Each arm of the DLC may provide cross-guarantees in respect of the obligations of the other arm so that if one of the companies has a higher rating than the other, the cross-guarantee should enhance the rating of the weaker company.

Tax

The success of a cross-border DLC structure from a tax perspective hinges on the idea that the combination largely retains the existing tax structures for the two companies as well as for their shareholders.

Capital gains

On a synthetic DLC and a twinned share structure, there is normally no disposal of assets by the companies so no liability to tax on capital gains arises. Likewise there is normally no disposal of shares by shareholders which avoids the difficulties that may arise on a conventional takeover in obtaining a capital gains tax deferral (roll-over) in some jurisdictions.

On a combined group structure, by contrast, capital gains may be more of an issue at the corporate level as assets will be moved underneath an intermediate holding company. This movement of assets will need to be carefully structured to ensure that no material tax charges arise or that any tax charges are manageable.

Tax on dividends

In a DLC, dividends generally continue to be received by shareholders from a company resident in the same jurisdiction. This is normally beneficial because domestic dividends often carry tax credits or exemptions and withholding tax may be deducted if dividends are paid from a foreign source. For example, UK corporates holding shares in a UK company in a DLC can continue to receive their dividends tax-free and UK individuals can continue to obtain the 10% tax credit attaching to domestic dividends.

In a combined group structure, to mitigate tax leakage, it should be possible to use 'income access shares' to enable a parent company within a jurisdiction to receive dividends directly from subsidiaries in that jurisdiction rather than having those dividends routed through an intermediate holding company in another jurisdiction. (Income access shares typically entitle the shareholder to receive dividends as determined by the directors and have no other economic rights.)

Stamp duty

On a synthetic or twinned share DLC no stamp duty or similar transfer taxes should arise if there is no transfer of assets between the parent companies and no transfer of shares by shareholders. This can be a significant saving when contrasted with a conventional takeover. For example, a takeover of a UK company may give rise to a charge of 0.5% of the consideration and, therefore, a £1 billion offer would be subject to a stamp duty charge of £5 million.

In a combined group structure, as for capital gains, the stamp duty implications of any movement of assets between companies will need to be considered carefully to ensure that these movements can take advantage of available exemptions.

One disadvantage of a twinned shares structure is that, where shares in a non-UK company are twinned with a UK company's shares, as in the Eurotunnel structure, future transfers of the units may be subject to 0.5% UK stamp duty reserve tax ("SDRT"). SDRT normally attaches only to agreements to transfer shares in a UK-incorporated company but, as a result of the Eurotunnel structure, the scope of the tax was extended so that it may, in certain circumstances, cover shares of a foreign company which are twinned with a UK company's shares.

Two particular tax issues which can prove to be challenging are residency and equalisation payments.

Tax residency

It is important that the tax residence of the companies which are party to a DLC is maintained. A change in tax residence would affect the tax treatment both of the companies and of the dividends received by shareholders.

The equalisation agreement normally provides for identical boards or some other mechanism to ensure that decisions relating to both parent companies are the same. This may cause a concern that central management and control of the companies is exercised from the same jurisdiction. This may in turn alter the residence of one of the companies, although this is dependent on the particular domestic law and the terms of any applicable double tax treaty.

In the UK, the normal rule is that a company is UK resident if incorporated here or centrally managed and controlled here. However, if a company is also regarded for the purposes of a double tax treaty as resident in another jurisdiction, it is not treated as UK resident.

Equalisation payments

The contractual equalisation arrangements entered into by the two parent companies in a DLC will usually provide for payments or other transfers to be made between those companies where one lacks sufficient profits or distributable reserves to make distributions. However, such payments, if made, may be very tax inefficient. For example, a payment may be treated as a taxable receipt by the receiving company without any corresponding tax deduction for the other company. In practice, therefore, companies will wish to structure their operations on an ongoing basis so as to ensure that no payments need to be made under the equalisation arrangements.

US tax concerns

There have not yet been any DLCs involving a US incorporated company. There have been concerns that a DLC might give rise to a partnership for US tax purposes, which may subject the UK company and its shareholders to US tax.

The Carnival/P&O Princess DLC did not in fact involve a US incorporated company – only a US listed company. Carnival is a Panamanian corporation, which is not resident in the US and enjoys an exemption from US federal income tax on its US-source shipping income. P&O Princess also benefits from the same exemption. It was therefore a very important consideration in structuring their combination that these exemptions should be preserved.

Unification

There has in recent years been a trend towards the unification of DLC structures into single corporate entities (for example, the Fortis DLC was merged in 2001 – *see below*).

Reasons for unification

Whilst some DLCs have been in existence for many years (such as Royal Dutch/Shell, established in 1907) others last only a few years. It can be the case that, whilst a DLC was the preferred means by which to begin to combine two companies (due to, for example, concerns of national identity), once the companies have been operating as a group for a few years, it may become preferable to merge the companies in a more traditional manner.

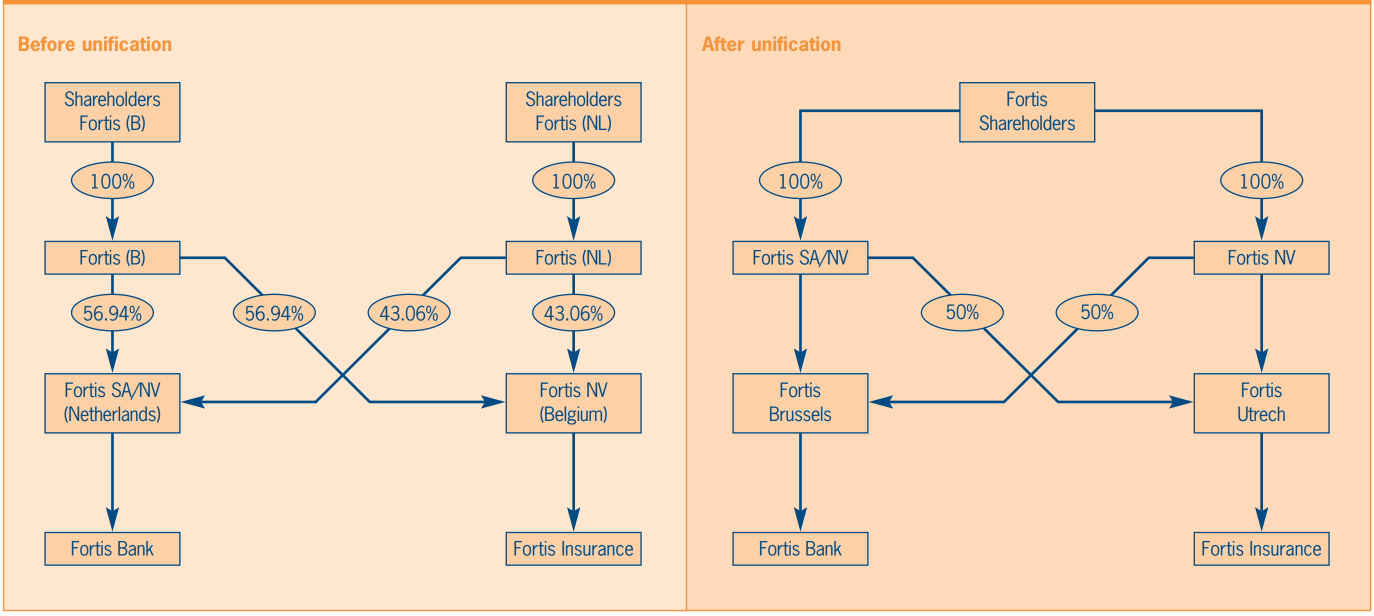
Maintaining separate listings, while attractive at the outset, can create difficulties when, with time, the shares in the different markets trade at different prices.

Similarly, the desire to enable the raising of finance in two markets at the outset can be compared with the fact that, as separately listed companies, there may be less market visibility than would be the case with a combined entity listed on one exchange.

The complexity of corporate and management structures and occasional conflicts between the top-tier companies can also place strains on a DLC structure which may not exist if the companies merged.

In the case of a DLC, there is also the disadvantage that the synergies which may be available in a traditional takeover are restricted.

Fortis – synthetic: 1998 – twinned shares: 2001



Fortis unification

In 2001 the Fortis DLC, which was structured as a synthetic DLC, was in part merged. The synthetic structure was replaced with a twinned share structure under which the cross holdings of each top company in the assets of the other company were equalised to 50% having previously been represented by a 57-43 split *(see box 'Fortis')*. In this way, the companies were able to maintain their national identities, but they were able to achieve greater unity between the two companies than was the case under the separate entities structure.

Carnival/P&O Princess

In April 2003, Carnival Corporation and P&O Princess Cruises plc (New York and London listed cruise companies respectively) entered into a DLC structure under which Carnival remains listed in New York and P&O Princess remains listed in London.

The completion of the DLC was the culmination of a two-way battle for the hand of P&O Princess, which had been fought between Carnival and Royal Caribbean Cruises Ltd since September 2001.

The deal involved an initially hostile offer by Carnival for the entire issued share capital of P&O Princess in the face of an agreed DLC transaction to be entered into between P&O Princess and Royal Caribbean. Following regulatory clearances, Carnival's share exchange offer was converted into a recommended DLC transaction between P&O Princess and Carnival, which included a partial share offer by Carnival for up to 20% of the share capital of P&O Princess.

Time line

November 2001: P&O Princess and Royal Caribbean announce their proposal to implement a merger under a dual listed company structure.

February 2002: P&O Princess EGM to approve the P&O Princess – Royal Caribbean DLC is adjourned in order to allow the EC and US regulators to consider the Carnival offer and the Royal Caribbean DLC together.

July 2002: European Commission clear Carnival's and Royal Caribbean's proposals.

October 2002: Federal Trade Commission clear Carnival's and Royal Caribbean's proposals, and P&O Princess announces that Carnival's proposal is superior. Carnival announces a new proposal, to implement a DLC structure with P&O Princess.

April 2003: Carnival/P&O Princess DLC combination completes.

Hostile to agreed

Carnival's offer was initially a hostile offer for the shares of P&O Princess, in competition with an agreed DLC transaction between P&O Princess and Royal Caribbean. Carnival had to overcome a number of deal protection mechanisms put in place by P&O Princess and Royal Caribbean. Following regulatory clearances, P&O Princess determined that Carnival's proposal was both feasible and financially more attractive than a DLC with Royal Caribbean.

Under the terms of its agreement with Royal Caribbean, P&O Princess was then able to discuss a DLC with Carnival. This gave Carnival the opportunity for the first time to convert what had been a hostile share exchange offer into a recommended DLC company transaction.

In order to give shareholders an opportunity to hold shares in Carnival rather than P&O Princess, a partial share exchange offer was also proposed. Carnival offered to exchange up to 20% of the share capital in P&O Princess for new shares in Carnival.

Structure of the DLC

The DLC was a synthetic structure under which the corporate structure of the two companies remained unchanged. The companies entered into a series of agreements which had the effect of equalising the economic and voting interests of the shareholders of Carnival and P&O Princess.

Takeover protection

Following the implementation of the DLC structure, neither Carnival nor P&O Princess are companies to which the Takeover Code applies because the Panel ruled that the central management, for Code purposes, of each company was outside the UK. Rule 9 and other shareholder protections afforded by the Takeover Code would not apply to P&O Princess. Synthetic provisions are therefore included in the articles of both companies providing that, in the event that a person acquires more than 30% of the voting rights in the DLC on a combined basis, it must make an offer to buy the entire share capital of both companies, or be disenfranchised and risk its shares being transferred to a trust, or sold.

Mandatory exchange

The constitution of P&O Princess contains special provisions so that, in certain triggering circumstances (for example certain changes in tax treatment, or illegality of the DLC), a vote can be put to the P&O Princess shareholders by which, with a two thirds majority of P&O Princess shareholders, all P&O Princess shares will be mandatorily exchanged for Carnival shares. This provides a route for the collapse of the DLC and the takeover of P&O Princess by Carnival in certain circumstances.

Stapled stock

The shareholders of Carnival and P&O Princess effectively cast their votes in each others' meetings through special voting shares. The P&O Princess special share was issued to a trust for Carnival shareholders. Carnival shareholders hold an interest in the special share pro rata to their actual holding in Carnival. The pro rata interest of each Carnival shareholder in the special voting share in P&O Princess is stapled to their Carnival shares with the resulting "unit" listed and traded on the NYSE.

Regulatory changes

In response to concerns regarding the way in which DLCs were dealt with in the Takeover Code and the Listing Rules, changes were recently made to those regimes.

The original DLC proposal between Royal Caribbean and P&O Princess was not subject to the Takeover Code, although the Code did apply to Carnival's competing offer to acquire the shares in P&O Princess. As a result of this there was something of an uneven playing field between the two bidders. The Takeover Code has since been amended so that it applies to DLC transactions. This did not apply to the Royal Caribbean DLC proposal but it did apply to the subsequent Carnival DLC proposal.

The UKLA's Guidance Note 3 requires the UK arm of a dual headed structure to have at least a 30% interest in the merged business. The UKLA confirmed in May 2003 that this applies only to a combined group structure and not to DLCs operating a synthetic structure. Instead, the UKLA indicated that prior to the establishment of a DLC with a UK listed arm, the UKLA should be approached at an early stage to discuss the detail of the transaction and the application of the Listing Rules to the resulting group.

In its Review of the Listing Regime, published in October 2003, the FSA announced that it is reviewing the classification of DLC transactions. Any changes are likely to be made in 2005. DLCs are already classifiable, but are dealt with on an individual guidance basis.

Finally, the introduction of the European public limited liability company (Societas Europaea) towards the end of 2004 will provide a further structural choice for cross-border mergers and its impact on the increased use of DLC structures will be interesting.

Credentials

Herbert Smith, Gleiss Lutz and Stibbe have advised on the following DLC transactions:

- Carnival/P&O Princess (2003) – Herbert Smith and Gleiss Lutz
- New Fortis (2001) – Stibbe
- BAT/Zurich (1998) – Herbert Smith
- Merita Nordbanken (1998) – Herbert Smith
- Fortis (1998) – Stibbe
- Dexia (1996) – Stibbe
- Eurotunnel (1987) – Herbert Smith and Stibbe

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