

**Hostile Takeovers in Germany.
A Case Study on Pirelli
vs. Continental AG**

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**Hostile Takeovers in Germany.
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I. Introduction

Recently the attempt of Pirelli SpA, Milan, to take over the German tire company Continental AG was warded off successfully by Conti. The fight between the two tire makers had lasted for more than 2 years and ended with the sale of the stake of Pirelli in Conti to a group of German institutions. The case is interesting enough not only from the perspective of the two companies, their shareholders, allies and competitors, but also because of the legal issues which arised during the bitter battle as well as some policy questions which were put in foreign and domestic media with respect to this case: Did German banks, politicians and firms rally behind the German target in order to thwart a foreign competitor's attempt to get a foothold in one of Germany's largest firms? Are there still institutional features and instruments available and used which impede a growing-together and further development of one single European market?

The following remarks will try to retell the story of Pirelli's takeover attempt, the reasons for its final failure and raise some of the issues concerned.

II. The Opponents and Their Industry

In 1990, the tire industry was topped by Michelin (France), followed by Goodyear (U.S.A.) and Bridgestone (Japan). Continental and Pirelli were 4th and 5th, respectively.

COMPANY	COUNTRY	MARKET SHARE
Michelin	France	24 %
Goodyear Tire and Rubber Company	USA	19 %
Bridgestone Corporation	Japan	17 %
Continental AG	Germany	8 %
Pirelli SpA	Italy	8 %

TABLE 1 - WORLD MARKET SHARES¹

Continental group was in 1990 33rd in the list of the 100 largest German firms measured by turnover; in 1989 it had a turnover of DM 8.3 bn. and 46,849 employees². Continental's main markets are Germany, Northern Europe, North America (General Tire Inc., Akron/Ohio), and Mexico. Pirelli's turnover in 1989 was over DM 14.0 bn.; it employed approximately 69,000 people. Its strengths are in Italy, Northern Europe, North America (Armstrong Tire Co.) and South America. Pirelli's tire production is under the control of the Dutch holding company, Pirelli Tyre Holding N.V. which has repeatedly attempted in the past to increase its market share through acquisition or joint ventures³.

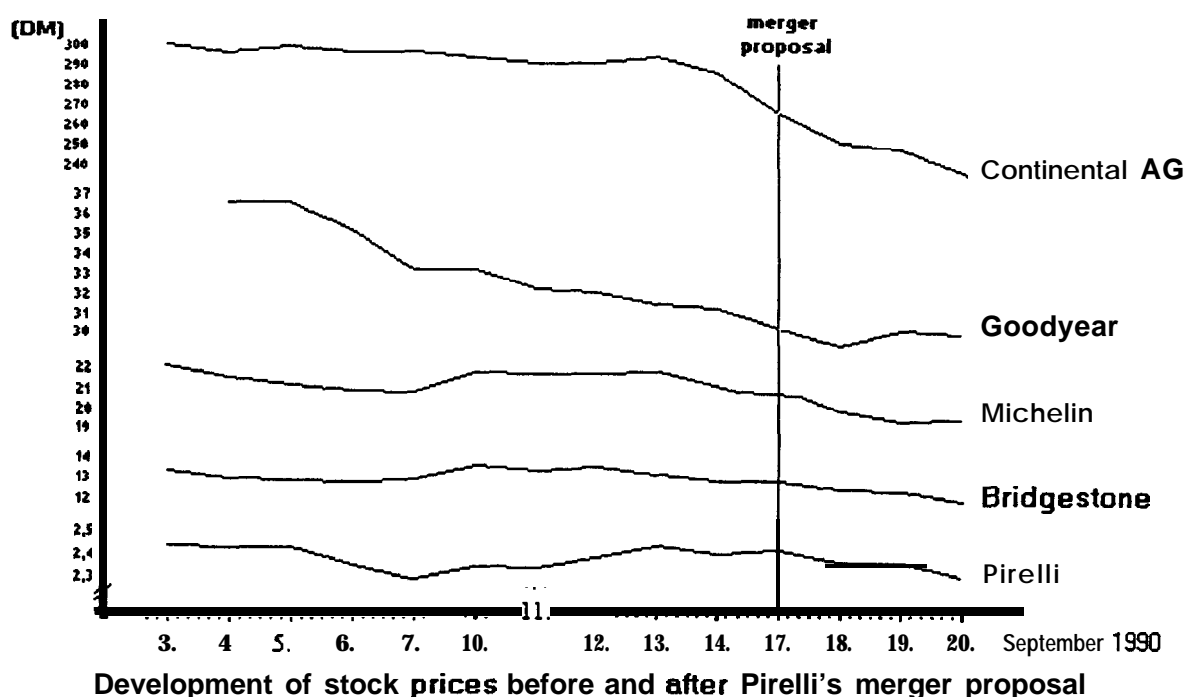
III. The Offer of Pirelli

On September 14th, 1990, Pirelli SpA submitted a merger offer to the chairman of the management board (Vorstand) of Continental, Horst W. Urban. Pirelli proposed a "reverse merger", demanding that Continental AG buy all assets of Pirelli's tire subsidiary, the Dutch Pirelli Tyre Holding N.V., for cash. The exact purchase price was left to further negotiations, but from its calculating examples it became clear that Pirelli expected a purchase price somewhere between DM 1.85 bn. and DM 2.25 bn. Continental was asked to increase its stock capital in the range of 50 - 66 % of its entire share capital outstanding in order to get the means to finance the acquisition of

Pirelli Tyre Holding's assets. The rest of the purchase price would have to be financed by taking on new loans of DM 0.4 - 1.25 bn. Pirelli itself would then use part of the consideration to buy sufficient newly issued Continental stock to acquire control of the German tiremaker⁴. It was contended by Pirelli in its proposal that its plans were supported by a group of Italian and German investors who allegedly held more than 50 % of Continental's stock. Pirelli did not, however, reveal who these investors were. It pointed out that this group planned to tender the new shares stemming from the capital increase in Continental to Pirelli Tyre Holding N.V. It would thus reach a majority within this group. Accordingly, the supervisory board⁵ of Continental would have, according to Pirelli's proposal, to represent the new shareholding structure in the future, and the management of Continental was expected to follow the strategic orientation of the Pirelli group.

Pirelli explained its Suggestion as an effort to catch up with the other three leading competitors on the world tire market by combining the market shares of Pirelli and Conti up to 16 % as well by uniting their R&D activities, manufacturing technologies and customer Services. From these synergies it expected an improvement of consolidated operating results before taxes of more than \$ 250 million over a four-year time frame after the merger. All this would then, according to Pirelli's proposal, provide the necessary basis for improved returns to all shareholders of both groups and benefits to their employees.

As a consequence of Pirelli's proposal, Continental's share price dropped.



IV. Legal Considerations

How could Pirelli's plans be implemented? To start with, German company law (§§ 339 ff. Aktiengesetz - Stock Corporation Act) does not allow a true cross-border merger with a Dutch N.V. (Pirelli Tyre Holding N.V.) which would result in the dissolution of the Dutch N.V. and the transfer of all assets to the "incorporating" German stock corporation (Continental AG) in exchange for a participation of the shareholders of the dissolved Dutch N.V. in Continental AG⁶. Hence there were mainly only two ways left.

Continental AG could raise its share capital (nominal capital - "Grundkapital") of about DM 435 mill. by issuance of new shares and hand out these new shares to Pirelli SpA or its Dutch subsidiary in exchange for its Pirelli Tyre holding business. The assets of this Dutch subsidiary would then be transferred to Continental as a "contribution in kind" (Sacheinlage; cf. § 183 AktG - Stock Corporation Act). This would, however, require that the preemptive rights of the other (old) shareholders of Continental be eliminated⁷. There are two hurdles on this way: First, the exclusion of the preemptive rights can only be effected by conclusion of the shareholders in a shareholders' meeting who hold shares equivalent to at least three quarters of the firm's capital represented in the meeting (§ 186 [3] Aktiengesetz); the Statutes of the corporation must not provide for a lower majority. Second, the courts will, upon request of a shareholder whose preemptive right was excluded, investigate whether such exclusion was reasonable and necessary to reach the aim of acquiring Pirelli's tyre business⁸.

Because of these difficulties, Pirelli proposed to choose another way⁹. Conti was asked to raise its capital without excluding its shareholders' preemptive rights. This can be effected in principle - if the Statutes of a Company provide for that which Continental's Statutes did - by a conclusion in the shareholder's meeting with the simple majority of the votes cast. Continental then would use the cash paid in by its shareholders to buy Pirelli's Dutch tyre business. In order to get control over Conti, Pirelli would then have to buy a controlling block of these newly issued shares from the group of shareholders which allegedly agreed with Pirelli's plans.

Figure 1

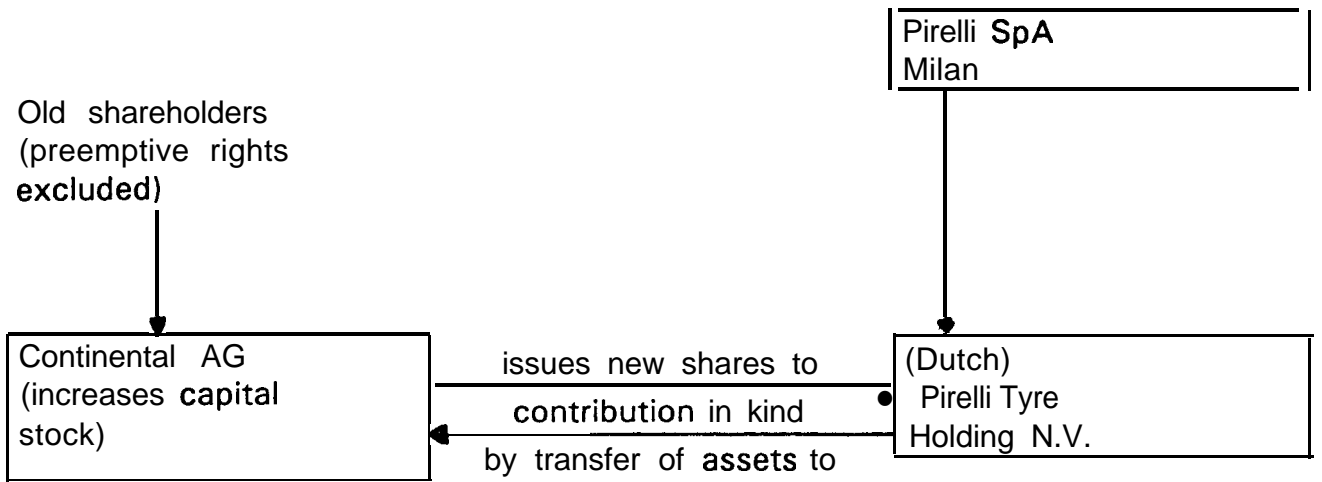
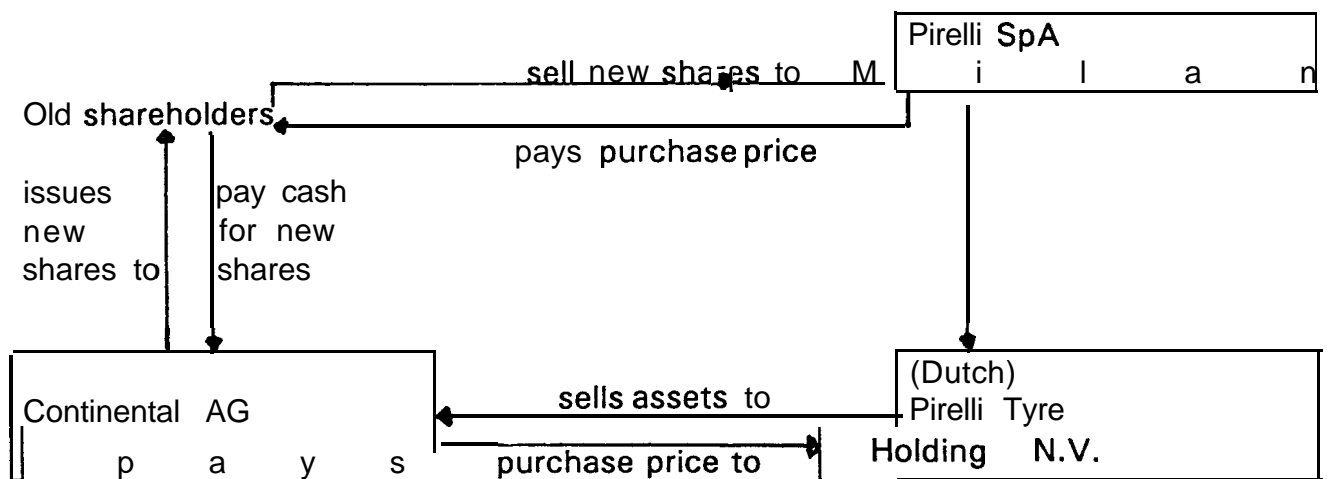


Figure 2 (Pirelli proposal)



This plan, however, touched upon two other critical issues of which only one was mentioned by Pirelli in its proposal. The arrangement which Pirelli proposed could be considered to be a circumvention of the rules of the Stock Corporation Act concerning contributions in kind (Sacheinlagen). According to this circumvention doctrine it does not matter whether a shareholder, instead of contributing **assets** as in a true **case** of a contribution in kind, promises to **contribute** in cash **when subscribing** for new shares, and then **sells assets** to the **company** and gets his cash contribution back as his **purchase prize**. In both **cases** the subscriber will be submitted to the rules governing contributions in kind and, as he did not comply with these rules in the second **case**, he will have to pay the cash contribution once again. The same circumvention doctrine would apply also to a **seller of assets** if a third **party** subscribed for new shares provided that this person acted upon the request and at the risk of the **seller**¹⁰. If the group of friends of Pirelli (the Pirelli "support group") who allegedly already held the majority of shares of Conti acted upon request and at the risk of Pirelli the whole transaction could hence be considered to be in **fact** a contribution in kind and be submitted to the rules **applicable** thereon.

The second hurdle for Pirelli's plans emerged from the cap on the voting rights on Conti's shares in the Statutes of this target Company. Continental AG belongs to the group of (in 1990: 22) publicly held stock corporations which have adopted provisions in their Statutes to the **effect** that no one shareholder may vote more than (in Conti's **case**) 5 % of all shares of the **company**¹¹. This rule would mean a **clear obstacle** to Pirelli's **plans** to gain and exercise control over Conti and its management in the future. Pirelli and his friends could not **change** this statutory Provision on their own even if they held the majority of shares in a shareholders' meeting as, according to a resolution adopted at Conti's 1989 shareholders' meeting, to waive or amend articles of the Statutes of Continental required a 75 % **majority**¹². Hence Pirelli asked in its letter that this statutory cap on the voting rights **be** eliminated first.

V. Continental's Governance Structure

Only a few days **after** Pirelli's letter, Continental's management as well as its supervisory board decided to reject the proposal and said an alternative proposal would be presented to **Pirelli**¹³.

At this point, some remarks about the governance structure of Continental seem appropriate. Being a stock corporation ("Aktiengesellschaft"), Continental has a management board ("Vorstand") and a separate supervisory board ("Aufsichtsrat"). Interlocks between these two organs are forbidden. Management is appointed, mostly for five years, and dismissed by the supervisory board. In 1990, the management board of Continental AG consisted of 8 members and was chaired by Mr. Horst Urban. The management board of an Aktiengesellschaft runs the firm independently in its day-to-day business and can be recalled only for cause. It has to report to the supervisory board periodically and to ask for its consent to certain major transactions (like, e. g., the acquisition of the assets of the Dutch subsidiary of Pirelli).

As Continental AG employs more than 2,000 employees, it is subject to the rules of the Codetermination Act of 1976 (Mitbestimmungsgesetz). That means that half of the members of its supervisory board are appointed by the shareholders and the other half by the employees (blue and white collar as well as lower-ranking management) and by labour Unions. Thus the codetermination rules prove - unintentionally but warmly welcomed by managements - to be another structural impediment to hostile takeovers as an acquirer would have to deal with the workforce's and the unions' representatives on the supervisory board. - In 1990, the supervisory board of Continental consisted of 20 members, half of them elected by the shareholders, the other half of them being representatives of the workforce. Its chair was held by Dr. Ulrich Weiß, at the same time member of the management board of Deutsche Bank AG¹⁴. Later on, after the failure of the merger talks, Pirelli maintained that there had been several meetings between the chairmen of the board of Pirelli and the supervisory board of Conti before its official proposal, and that the latter had given his agreement and support to Pirelli's plans¹⁵. Pirelli claimed further that Deutsche Bank had advised it initially in its merger plans whereas it acted afterwards, through its subsidiary Morgan Grenfell, as an advisor to Conti's management in the takeover battle¹⁶. Only incidentally I note that also Gerhard Schröder, Prime Minister of the (Federal State of) Lower Saxony, Social Democratic Party, had talks with Leopoldo Pirelli after Pirelli's offer and declared that he fully supported a combination of both groups¹⁷. I will get back to

Schröder's role and his understanding of an **active** "Industriepolitik" later (XI., below).

VI. The Failure of the Merger Talks

In his answer to Pirelli the speaker of the management board Mr. Urban claimed that the purchase price asked by Pirelli was far above market levels. Pirelli's business was worth only 800 million. However, Continental offered to hold merger negotiations, provided that talks were held in private, all information kept confidential, and that Pirelli as well as its "support group" agreed to a stand still agreement¹⁸. Pirelli and through it the members of its "support group" were asked to - within the next three years - abstain from any trading of Continental's stock, trying to change Continental's charter in order to eliminate the 5 % voting cap, or supporting the law suit of one of Conti's shareholders concerning the 1989 charter amendment resolution¹⁹. As Pirelli refused to sign this agreement, Continental said it considered the offer as hostile and would resist a forced merger²⁰. Hence the question whether an agreement between the management board which acts on behalf of the corporation and its shareholder(s) on how the shares are to be voted in future is void or is legally binding under German law, remained unresolved.

Finally, in a letter to the shareholders as of Jan. 21, 1991, Continental's executive and supervisory boards declared that they had decided to end merger talks with Pirelli²¹.

The main reasons which were put forward in that letter²² were:

The price range of DM 1.85 - 2.25 bn for Pirelli's tyre assets was wholly excessive. The market capitalisation of Pirelli Tyre in December 1990 was DM 0.73 bn. Pirelli had claimed that Pirelli Tyre was significantly undervalued by the stock market and should represent as much as 45 % of the valuation of the combined group. On the basis of Continental's market capitalisation as of Dec. 1990 of DM 1.8 bn, this would have valued Pirelli Tyre at up to DM 1.47 bn. This was, according to Conti and its advisors who had undertaken a valuation of Pirelli Tyre on the basis of public

information, an unjustified premium of 100 % to its **current** market capitalisation.

This premium were to be paid by Continental despite the **fact** that those of its shareholders not associated with Pirelli would have ceded control of the business to Pirelli and therefore they, and not Pirelli, should be the recipients of a control premium.

- Continental would have to take on substantial loans to finance the **purchase** at a time when conditions in the tyre industry were deteriorating **substantially**²³.

Although a merged group would have substantial market shares in Europe, a merger would give rise to only limited opportunities for additional **sales** as the brands of the two firms were not interchangeable, and would in all probability lead to a **loss** of business from Conti's principal customers, the German automobile manufacturers, who did not wish to be over exposed to only one supplier.

Synergies **which** could result from a merger would be very limited, and management resources should not be diverted to **cope** with such a highly **complex** integration task **which** a merger of the two tyre firms would involve.

Pirelli Tyre's **recent losses** and indebtedness would impair a merged group's ability to pay dividends and obtain finance.

Continental's employees' representatives on the supervisory board were extremely concerned **about** the **implications** of a merger with Pirelli Tyre **since** they feared that it would materially weaken Continental and perhaps even result in lay-offs of employees.

Pirelli was not prepared to disclose the names of its associates **or** the arrangements between them.

This "support group" and the arrangements between its members are worth to be looked at more closely.

VII. **Pirelli's Support Group: Facts and Legal Issues**

In its initial proposal Pirelli had indicated that a group of German and Italian industrial and institutional investors who held shares in excess of 50 % of Conti's share capital had favourably valued Pirelli's merger plans, but had not revealed who these investors were. Pirelli had to build such an alliance of different shareholders because of the 5 % voting cap in Continental's Statutes.

1. **The facts**

Pirelli itself had started to purchase shares on its own up to 5 % of Conti's stock and to build its "support group" by mid of 1990²⁴. In order to gain the (simple) majority of all votes cast in a shareholders meeting a sufficient number of different shareholders (the exact number depending on the actual presence of shareholders in a shareholders' meeting²⁵) had to gather. In October 1990 Mediobanca, a leading Italian merchant bank, and Sopaf (Società Partecipazioni) SpA, Milan, revealed that each of them bought 5 % interest in Continental. Italmobiliare said it indirectly held 3 %²⁶. FIAT of Italy which first had confirmed to hold less than 4 % sold this stake off later, before the special shareholder's meeting in March 1991²⁷. It remained unclear who the other members of the support group were.

According to a ruling of the district court (Landgericht) of Hannover Pirelli had, in March 1991, in addition to its own stake of 5 %, a "pool agreement" with at least a further 20.4 % of Conti's stock and Options for another 9 %²⁸. According to this pool agreement Pirelli was obliged to compensate the respective investors for all losses and costs incurred, especially declines in the price of Conti's stock, whereas prize gains should stay with the investors. The summary of the facts mentions that Pirelli's support group had bought its shares (mill. 1,789,322) at a prize of DM 310, and that this prize had dropped by March 1991 to DM 214. - The partners of the indemnity agreement were obliged to bring all their influence to bear on Continental in order to achieve its merger with Pirelli as soon as possible. In particular they had promised to vote for the increase of Conti's capital stock in order to finance the purchase of Pirelli Tyre, for the repeal of the 5 % voting cap, and for the representation of Pirelli on the supervisory board.

Furthermore, they were obliged to transfer all newly issued shares to Pirelli in order to get Pirelli full control over Conti. Pirelli was entitled to give the other investors instructions how to vote on other matters. Lastly, the investors were prohibited from selling their shares to third parties and were obliged to transfer them to Pirelli at its request.

2. *Legal Issues*

The formation of the "support group" by Pirelli raises several legal issues.

a) The "Transparency Directive" of the EC²⁹ has not yet been transformed into German law. According to this directive each acquiror of stock of a Company will have to give due notice within 7 days to that Company if his or her amount of shares equals, surmounts or falls below certain thresholds (10 %, 20 %, 1/3, 50 % and 2/3, respectively). Shares which are held by a third party on the account of the acquiror have to be added to his own holdings. The German Stock Corporation Act (Aktiengesetz) only states a duty of a shareholder, if this shareholder is an enterprise and his participation surmounts one fourth of the corporation's capital, to give it due notice thereof (§ 20 Aktiengesetz). Shares which are held by a third party on the account of the shareholder have to be added. As long as this notice has not been given to the corporation, the respective shareholder must not vote his or her shares. As Pirelli had only told Conti that it was supported by a group of investors who all together held the majority of Conti's shares, but had not revealed the pool agreement, it had failed to give due notice to Conti that it commanded in fact more than one fourth of Conti's shares. Hence the district court of Hannover ruled later that Pirelli and his support group should not have voted their shares at the extraordinary shareholders' meeting which took place in March 1991, and that the resolutions that were passed during this meeting were void³⁰.

b) The draft of a Thirteenth Directive of the EC on takeovers (of Febr. 16, 1989) states a duty of any shareholder or investor who is about to acquire one third (the member states may lower this threshold) or more of the shares in a public Company to make a public offer to all shareholders to

take over their shares as well (Art. 4). Shares which are held by a third party on the account of the **respective** shareholder or investor have to be added. Pirelli would have been obliged to make such an offer to the **outside** shareholders of Conti if a **comparable** rule existed in German corporate law which is, however, not the **case**. German corporate law neither knows of a conclusion of the shareholders in a shareholders' meeting on whether control may be sold to a shareholder or investor who seeks to **get control** nor does German corporate law know of a right of the outside shareholders to tender their shares to him. It rather **tries** to protect the outside shareholders **ex post**, after the Company got **under** control of an **other** enterprise, by the provisions of its law of "group of companies" ("Konzernrecht") which, however, leaves quite some **problems unresolved**³¹.

c) One of the attempts of German corporations to protect themselves against unwanted shifts of control are voting **caps** or maximum voting rights ("Höchststimmrechte"). They are, however, a comparably inflexible and doubtful instrument as they do not serve to protect the outside shareholders in the Situation of a (hostile) takeover in the first line but rather inhibit a **change** of control at all and thus protect incumbent management³². Furthermore, they **can** be circumvented. The Stock Corporation Act provides that a statutory voting cap of, say, 5 % **restricts** also those shares which are held by a third **party** for the account of a shareholder (§ 134 (1) (3) Aktiengesetz). However, it is difficult to find out whether shares are held for the account of another shareholder. If Pirelli **SpA** had not **disclosed** itself that it was **backed** by a group of investors who were willing to support its efforts to gain control, but had simply voted in a "concerted **action**" with them to repeal the voting cap on Conti's shares in the shareholders' meeting, it would have been difficult, if not impossible, to **discover its** contravention of Conti's statute which happened in a shareholder's meeting in March 1991 when Pirelli together with all other members of its support group **cast** their votes. We turn to this shareholders' meeting now.

VIII. The Extraordinary Shareholders' Meeting and the Conti Support Group

On Dec. 12th, 1990, Continental received a request from Mr. Alberto Vicari, Wiesbaden, representing a 5 % **shareholding** in Continental, that a meeting

of Continental shareholders should be convened in **order** to remove the many uncertainties about the fate of Continental AG and the "state of suspense" (Schwebezustand) complained about even by Conti's management.

7. *Vicari's proposals*

According to Mr. Vicari, the shareholders' meeting should **determine** whether Conti should proceed with a merger with Pirelli Tyre Holding N.V. or alternatively take **steps** to strengthen Continental's independence. The pending **structural** questions and investment decisions of fundamental **importance** represented such a **significant** interference with the rights and interests of the shareholders of Continental AG, that the Vorstand (management **board**) could not make such **far-reaching** decisions exclusively based on its own responsibility. Therefore, the Shareholders' Meeting, **as the** supreme body, had to consider these matters³³.

In order to reach this goal Mr. Vicari put forth five proposals on which the shareholders' meeting was asked to vote.

1. Amendment of the articles of incorporation: A waiver or amendment of the voting rights limitation of 5 % shall require a majority of at least **3/4** of the votes **cast** and of the stated **capital** represented at the meeting (In their Statement on Mr. Vicari's proposals Vorstand and Aufsichtsrat recommended shareholders to vote for this resolution).
2. Amendment of the articles of incorporation: The voting rights limitation of 5 % in the articles of **incorporation** shall be eliminated (Vorstand and Aufsichtsrat recommended to vote aaainst this proposal).
3. Amendment of the articles of **incorporation**: The removal of members of the Aufsichtsrat (supervisory board) who have been elected by the shareholders' meeting shall require a shareholders' resolution adopted by a majority of at least **3/4** of the votes **cast** and of the stated **capital** represented at the meeting instead of the **actual**

simple majority requirement (Vorstand and Aufsichtsrat recommended to vote against this proposal).

4. The Vorstand shall take all necessary steps to allow the next ordinary shareholders' meeting to adopt a resolution that Continental AG shall acquire the tyre business of Pirelli Tyre Holding N.V. by way of an increase of the Company's stated capital through a contribution in kind, with the exclusion of the pre-emptive rights of the shareholders (Vorstand and Aufsichtsrat recommended to vote against this proposal).

5. Amendment of the articles of incorporation: The sale of any division of the Company which accounts for more than 25 % of the gross sales of the Company shall require a resolution adopted by the shareholders' meeting by a majority of at least $\frac{3}{4}$ of the votes cast and of the stated capital represented at the meeting (Vorstand and Aufsichtsrat recommended to vote against this proposal).

As Mr. Vicari held 5 % of Continental's stock, management was obliged to call the shareholder's meeting as requested pursuant to § 122 Stock Corporation Act (Aktiengesetz).

The critical question for Continental's incumbent management was whether Pirelli and its support group would have enough votes and companions to push the resolutions that were in favor of Pirelli's plans through (abolition of the voting limitation - proposal 2, supra; acquisition of Pirelli's tyre business - proposal 4, supra), or whether Pirelli would at least be able to thwart proposal 1 which was aimed at making it more difficult to remove the voting limitation³⁴. Generally a simple majority of the votes and capital represented at the general meeting suffices for resolutions on issues like Vicari's proposals 1 and 2 whereas proposal 4 - preparation of an acquisition of Pirelli's tyre business by way of an increase of the Company's capital with the exclusion of the pre-emptive rights of the shareholders - required a 75 % majority of the capital represented and a simple majority of the votes represented at the general meeting (§§ 186 (3), 83 (1) Aktiengesetz). As Continental's management at the time at which Vicari asked it to call the general meeting neither knew how large Pirelli's support group actually was nor was aware that there were binding agreements between the members of

this group which shrieved the votes of the whole group up to 5 %³⁵, it tried to put a "Continental management support group" together in its turn.

2. ***The "Continental Management Support Group"***

In February 1991 the financial press reported that the investment bank Morgan Grenfell, a subsidiary of Deutsche Bank AG and advisor to management of Continental in its antitakeover struggle, had succeeded in forming a group of shareholders of large German firms who had decided to ward off Pirelli's plans. The group was said to hold a "blocking majority" of at least 25 % of Continental's capital plus 1 share. Members of this management support group were reported to be: Allianz AG (Germany's largest insurer) with a stake of 5 %; Deutsche Bank with 5 %; the German car industry (BMW, Volkswagen and Daimler-Benz) with a total of about 7 %, Dresdner Bank with 3 %, and other major financial institutions like Norddeutsche Landesbank, Bayerische Vereinsbank and others with about 5 %³⁶. This group was at least able to block all conclusions which requested a 3/4 majority of the capital represented in the shareholders' meeting as, for instance, in the forthcoming extraordinary shareholders' meeting set for March 13, the proposal to require the executive board (Vorstand) to take the steps necessary for a merger (proposal No. 4, supra). When Pirelli became aware of that, it announced, one day before the shareholders' meeting, that it planned to abstain from the merger vote (proposal 4, supra)³⁷. FIAT which apparently did not like to clash with the German car manufacturers declared by March 11, 4 days before the special shareholders meeting, that it had sold off all of its stake in Continental³⁶.

3. ***The Extraordinary Shareholders' Meeting***

The extraordinary general meeting was held on March 13, 1991. The actual result of it was that all of the resolutions except proposal no. 2 (elimination of the 5 % voting limitation) were voted down. That means that, on the one hand, the 5 % voting limit was removed, but that, on the other hand, a mandate to the management to seriously consider the merger was not issued. The votes for the resolution concerning the voting limit constituted a 65.97 % majority of the shares represented at the meeting and remained

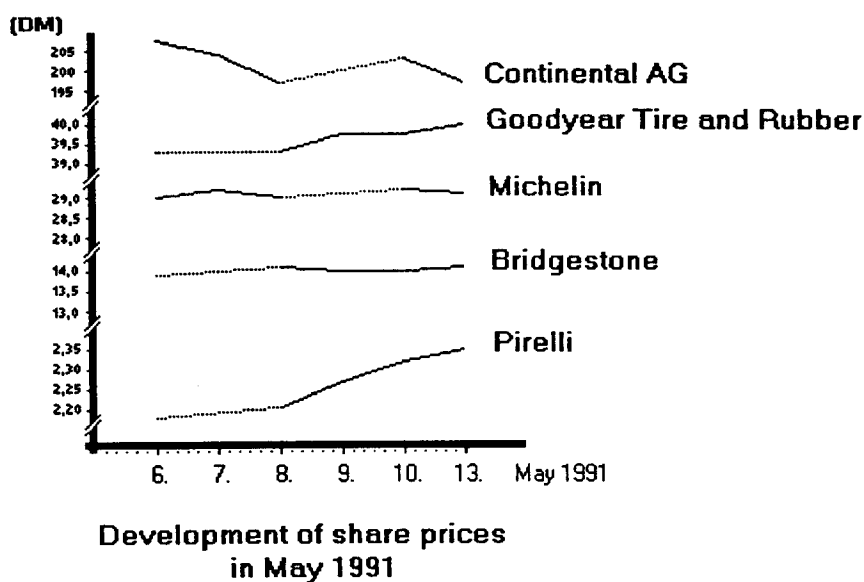
just under 50 % of the actual shares outstanding³⁹. As Pirelli's support group had voted in favor of this proposal no. 2, this revealed that Pirelli's claim of majority control of Continental was overstated. By looking at the abstentions on the merger resolution (proposal no. 4, supra), the shares under Pirelli's control was estimated to be 36.4 % of the capital stock⁴⁰.

Later, an action was brought by two shareholders of Conti on the grounds that Pirelli and its support group had acted illegally by voting shares without having given due notice to Continental pursuant to § 20 Stock Corporation Act, and by circumventing the statutory voting limitation of 5 %⁴¹. Accordingly, the district court (Landgericht) of Hannover ruled on May 29, 1992 that the repeal of the voting limit by conclusion of the extraordinary shareholders's meeting was void⁴².

IX. The Resignations of the CEOs

After the special shareholders' meeting at Hannover the merger attempt was at a standstill. The 5 % voting cap was lifted, but the validity of this conclusion was contested in court. On the other hand, the shareholders had not given the executive board a mandate to prepare an increase of Conti's capital stock in order to achieve a merger with Pirelli. German as well as Italian shareholders had taken considerable stakes in Conti, and Pirelli was threatened by the Obligation to take over huge losses because of the dropping prizes of Conti's shares held by Pirelli's support group. Both sides had to consider new talks between the companies. The confrontational approach of both sides had to be moderated first, and the proponents of this strategy on both sides to be exchanged. First the chairman of the executive board of Conti, who had been heavily criticised in the media for his attempt to entrench management and for his total Opposition to a merger with Pirelli was toppled. In an unscheduled meeting on May 9, 1991, Continental's supervisory board met and accepted Mr. Urban's resignation. The board signalled to Pirelli that cooperation talks could start again if Pirelli would hold off on demanding to place two of its own representatives on Conti's board⁴³. As Pirelli agreed, talks were resumed under the condition of strict confidence and that no preconditions be put by either sides.

Conti's as well as Pirelli's share prices increased as rumors about a resignation or dismissal of Mr. Urban grew.



Then, on June 24, 1991, the managing director of Pirelli, Mr. Gianbattista De Giorgi, who also had followed a confrontational course, stepped back. Leopoldo Pirelli, Pirelli's president, was said to prefer friendly rather than hostile talks⁴⁴. However, both groups remained divided in the following on the valuation of Continental shares purchased by Pirelli and its support group⁴⁵. On Dec. 2nd, Pirelli announced that it faced losses up to \$ 560 million for 1991, of which \$ 280 million were attributed to the indemnity agreement between Pirelli and its support group⁴⁶. The extent of these losses made a merger with Pirelli unattractive to Continental, and the talks between the two firms ended⁴⁷.

X. **Pirelli's Withdrawal**

After the talks had ended, Continental announced that it would look for other cooperation possibilities and strategic alliances. Pirelli had, because of the losses incurred, to restructure its capital by a rights issue that raised about \$ 420 million and the sale of Pirelli's diversified product division for around \$ 800 million. Leopoldo Pirelli resigned as CEO, allegedly because the banks had insisted on his resignation because of the huge losses of Pirelli and the negative Publicity connected with and the final failure of its merger attempt⁴⁸.

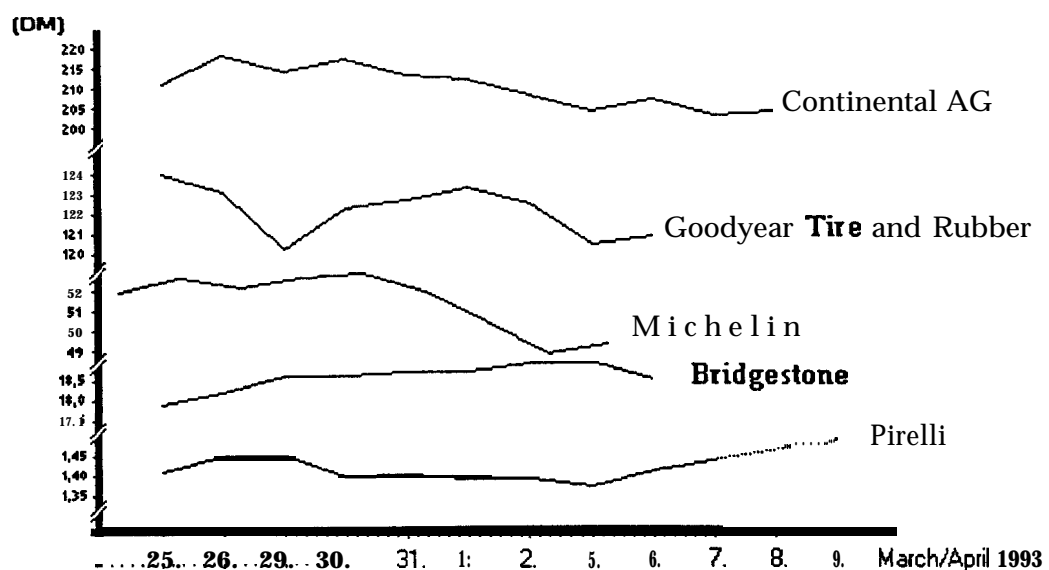
The struggle between Pirelli and Conti was not over, yet. It flared up again at the regular shareholders' meeting of Continental which convened on July 3rd, 1992. With respect to the almost 39 % of Continental stock controlled by Pirelli⁴⁹ the chairman of the meeting excluded Pirelli's and its allies' shares from voting because Pirelli had not given due notice of its stake of more than 25 % to Conti pursuant to § 20 Stock Corporation Act (Aktiengesetz). Because Pirelli and its group were excluded, another motion to remove the 5 % voting limitation was defeated, and Continental's management was approved by conclusion of the rest of the shareholders present. Pirelli immediately filed a suit against these conclusions which was retorted by Continental AG: Continental demanded that Pirelli pay the dividends (DM 8,9 million) which had been paid to it and its support group on their Conti shares in 1990 back⁵⁰.

All legal actions were finally settled end of March this year after Pirelli had decided to sell its whole stake in Conti to a German investor group. The following agreement was concluded and executed: Mediobanca retains a stake of 5 % in Continental. Pirelli exercises its Options it holds on its allies' shares and sells these and its own shares up to an amount of 18,2 % to Deutsche Bank AG. Deutsche Bank will retain 5 % on its own and place the rest with other German institutional investors like banks and insurances which are unidentified so far. 15 % of Pirelli's stake have been taken over by a group of companies from the state of Lower Saxony, where Continental is based. This group is headed by the (public) Norddeutsche Landesbank (which took over 6 %) and includes electrical utility PreussenElektra AG (5 %), Haftpflichtverband der Deutschen Industrie (HDI personal liability

trade association) and the insurance Company Versicherungsgruppe Hannover each of which took over 2 %⁵¹.

The whole stake of 2,934 million shares and Options of shares was sold by Pirelli for DM 330 million (\$ 208 million) which meant a premium for Pirelli of 21 % over Continental's closing price on the Frankfurt Stock Exchange of DM 207 (\$ 129.29) on Friday, April 2nd, 1993. Nevertheless a purchase prize of DM 250 per share still meant a huge loss considering a purchase prize of between DM 280 and DM 310 per share and the other costs which Pirelli had incurred⁵².

Satisfaction was nevertheless expressed on both sides. Continental's new executive board chairman Hubertus von Grünberg said with the decision of Pirelli to sell its stake in Continental AG, Conti had "won back full freedom of action and will use it in the best interests of the group of its customers, shareholders, and workers". Pirelli said that the Pirelli-Continental saga had "a good ending", because "it produces a cash inflow and a capital gain for Pirelli", a considerable profit for its allies and the conditions for the two tire makers "to go their independent ways".



Development of share prices before and after the publication (on Saturday, March 27, 1993) of the sale of the stake in Conti by Pirelli.

XI. Postscript: On the Role of the State in Take-over Battles

A postscript should be made with respect to the role of the state within the whole game, especially the Prime Minister of the federal state of Lower Saxony, the Social Democrat Gerhard Schröder. After Schröder initially had held talks with Leopoldo Pirelli on Pirelli's merger plans and declared his full support, he again interfered during the final agreement talks between Conti and Pirelli and explained after these talks that a "great success" had been achieved⁵³: The stake of Pirelli and other Italian allies were thus brought back into the hands of German investors, a solution which would also guarantee that a Japanese investor who also had shown interest in Continental in the meantime could be blocked successfully, too⁵⁴. This was apparently worth it for Mr. Schröder to take the finance risk for the operation on the state's budget. In order to finance the purchase price for the part of Pirelli's stake which was purchased by the Lower Saxon-group (Norddeutsche Landesbank and others), Norddeutsche Landesbank issued convertible bonds to the other members of the group which give these members the option to convert these bonds into shares between 1995 and 2000. The conversion is possible only with consent of the state of Lower Saxony. They bear annual interests of 6 per cent. The payments of the interests as well as losses resulting for Norddeutsche Landesbank from drops in share prices are guaranteed by the state of Lower Saxony up to an amount of DM 311 million plus an additional authorization to over DM 161,14 million⁵⁵. But what are these numbers compared to a total state debt burden of Lower Saxony of about DM 50 billion? They can easily be financed by slashing further expenses for, e. g., universities like in the past two years which only produce annoying studies like this one anyway.

- * Dr. jur., Professor of Law, Director, Institut für Handels- und Wirtschaftsrecht, Universität Osnabrück. Lecture, given at the European Centre for Advanced Research in Economics (ECARE), Université libre de Bruxelles, Brussels, May 27, 1993. I am grateful to Markus König for his research assistance.
- 1 Source: J. Hicks, "German tire Maker is Target of Pirelli Bid", New York Times, Sept. 18, 1990, p. C 5.
- 2 Source (with more detailed information) Saling Aktienführer 1991 at 177 - 179.
- 3 Source: C. Bagley/M. Dick/S. Pai, "The Attempted Merger of Continental and Pirelli", Stanford Business School Working Paper Jan. 1993.
- 4 Cf. thereto and for the following "Crucial Tactical Errors Trip Up Pirelli's Bid for Continental AG", Corporate Control Alert, January, 1992, at 1.
- 5 On the tasks of a supervisory board and the distinction between supervisory and boards see V., below.
- 6 Cf. Kraft, Kölner Kommentar zum Aktiengesetz Vol. 7 (2nd ed. 1990) § 339 notes 38 - 43 with further references.
- 7 See Figure 1, below.
- 8 Entscheidungen des Bundesgerichtshofes in Zivilsachen (Federal Court decisions in civil matters) Vol. 71 (1978) at 40 - 53.
- 9 See Figure 2, below.
- 10 See Lutter, Kölner Kommentar zum Aktiengesetz Vol. 1 (2nd ed. 1988) § 66 note 38.
- 11 "Höchststimmrecht"; cf. T. Baums, Höchstmstimmrechte, Die Aktiengesellschaft 221 - 242 (1990) with further references; for a different view see W. Zöllner/U. Noack, One share - one vote?, Die Aktiengesellschaft 117 - 131 (1991).
- 12 This resolution was, however, declared void on Dec. 20, 1990 by a court due to a defect in form; "Urteil gegen Continental", Frankfurter Allgemeine Zeitung, Dec. 21, 1990, at 18.
- 13 "Pirelli is Rejected", New York Times, Sept. 19, 1990 p. C 5.
- 14 Source of data: Saling Aktienführer 1991 (supra note 2); for further information and references on the governance structure of German publicly held corporations see T. Baums, Corporate Governance in Germany, The Role of the Banks, 40 AmJCompL, 503 - 526 (1992).

- 15 **Pirelli SpA Milan, Letter to the Shareholders, Febr. 4, 1991, Report, at 3 - 4; see also "Conti kämpft weiter gegen eine Übernahme durch Pirelli", Frankfurter Allgemeine Zeitung Nov. 5, 1990, at 19.**
- 16 **"Pirelli: Weiterhin freundliches Zusammengehen mit Continental", Frankfurter Allgemeine Zeitung, Dec. 19, 1990, at 19.**
- 17 **"Pirelli will bei Fusion Hannover als Firmensitz behalten. Ministerpräsident Schröder für Zusammengehen mit Continental", Frankfurter Allgemeine Zeitung, Sept. 20, 1990, at 19.**
- 18 **"Pirelli Offer to Merge Tire Lines is Rejected by Continental AG", Wall Street Journal Sept. 25, 1990, p. A 18.**
- 19 **"International Corporate Report: Continental AG", Wall Street Journal, Nov. 6, 1990, p. A 18; "Conti-Chef Urban: So nicht, Herr Pirelli!", Frankfurter Allgemeine Zeitung, Sept. 25, 1990, at 21.**
- 20 **"Conti kämpft weiter gegen eine Übernahme durch Pirelli", Frankfurter Allgemeine Zeitung Nov. 5, 1990, at 19.**
- 21 **"Continental Proposal Over Talks on Merger is Rejected by Pirelli", Wall Street Journal, Nov. 7, 1990, p. A 11.**
- 22 **Reprinted in: Continental Aktiengesellschaft, extraordinary Shareholders' Meeting March 13th, 1991, at 4 - 11.**
- 23 **Thereto also: "Continental beklagt Schwebzustand und Ertragsrückgang", Frankfurter Allgemeine Zeitung Nov. 22, 1990, at 18.**
- 24 **Bagley/Dick/Pai, supra note 3, at 4; see also Saling Aktienführer, supra note 2, at 179; "Der Conti-Vorstand ist beunruhigt über Aktientransaktionen", Frankfurter Allgemeine Zeitung, July 30, 1990, at 16.**
- 25 **If 100 % of the stock capital was represented, 11 shareholders were necessary to get the majority (10 x 5 % plus 1 share); with a presence of 70 % only 8 (7 x 5 % plus 1 share).**
- 26 **Bagley/Dick/Pai, op. cit., at 4, 8; Saling Aktienführer, supra note 2, at 179.**
- 27 **See thereto VIII, below.**
- 28 **Landgericht Hannover, Urteil vom 29.5.1992, Die Aktiengesellschaft 1993, at 187, 188.**
- 29 **EC Directive of Dec. 12, 1988 (88/627/EC).**
- 30 **Thereto VIII, infra; cf. Landgericht Hannover, supra note 28.**
- 31 **For a thorough discussion see the comparative study (on the U.S., U.K., and Germany) of R. Lüttmann, Kontrollwechsel in Kapitalgesellschaften (1992).**
- 32 **For a detailed discussion see the references cited supra note 11.**

- 33 Cf. the letter and the proposals of Mr. Vicari in: **Continental AG, Extraordinary Shareholders' Meeting, March 13, 1991**, (special print), at 1 - 3.
- 34 As became clear from their recommendations, the Vorstand and the Aufsichtsrat themselves were not interested in **proposals 3 (removal of members of the Aufsichtsrat) and 5 (sales of assets of Conti) to be adopted**.
- 35 Cf., VII.2., supra.
- 36 "Corporate Governance in Germany: Our Crowd", *The Economist*, Febr. 23, 1991, at 71 - 72.
- 37 Bagley/Dick/Pai, supra note 3, at 9.
- 38 See supra p. 11.
- 39 Landgericht Hannover, supra note 28, at 189.
- 40 Continental Aktiengesellschaft Annual Report '90 (English ed.) Dec. 31, 1990, at 11.
- 41 Cf. VII.2., supra.
- 42 Landgericht Hannover, Urteil vom 29.5.1992, *Die Aktiengesellschaft 1993*, at 187 - 190.
- 43 For the following see Bagley/Dick/Pai, supra note 3, part B, at 1 with further references.
- 44 Cf. also Leopoldo Pirelli's Letter to the Shareholders of Pirelli of Febr. 4, 1991.
- 45 "Continental and Pirelli Differences Narrow", *Financial Times*, Oct. 30, 1991, at 29.
- 46 Talks with Continental Collapse as Italian Group Faces Big Losses: Pirelli Crisis Thwarts Merger", *Financial Times* Dec. 2, 1991, at 1.
- 47 "Italy's Pirelli Controls Stake to Up to 39 % of Rival Continental", *Wall Street Journal* Jan. 14, 1992, at A 11.
- 48 Bagley/Dick/Pai, supra note 3, part B, at 3.
- 49 Bagley/Dick/Pai, supra note 2, part B, at 3.
- 50 "Italiener ziehen sich bei Continental zurück", *Frankfurter Allgemeine Zeitung*, April 6, 1993.
- 51 "Pirelli agrees to sell Continental holding", *Financial Times*, April 6, 1993; "Pirelli Closes Takeover Saga By Selling Continental Stake", *Wall Street Journal*, April 6, 1993, at 3.

- 52 For the numbers see Wall Street Journal, supra note 51; “Verkauf bringt Pirelli 330 Millionen DM”, Frankfurter Allgemeine Zeitung, April 6, 1993.
- 53 “Niedersachsen-Gruppe übernimmt Conti-Paket”, Neue Osnabrücker Zeitung, March 27, 1993, at 8.
- 54 Supra note 53.
- 55 “Italiener ziehen sich bei Continental zurück”, Frankfurter Allgemeine Zeitung, April 6, 1993.