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I OVERVIEW OF 2007/2008 M&A ACTIVITY

2007 was undoubtedly one of Spain's best-ever years for M&A, with not only many domestic deals but also the culmination of a number of high-profile cross-border transactions, e.g., the Endesa takeover by Acciona and Enel after a fierce two-year battle that also involved Gas Natural and E.ON; the joint acquisition of ABN AMRO by the consortium made up of Banco Santander, Royal Bank of Scotland and Fortis; and the acquisition of Scottish Power by Iberdrola.

After the M&A boom in 2006 and 2007, the prospects for 2008 are less promising. The final quarter of 2007 marked a downturn following the 'credit crunch' in summer 2007, and in the first quarter of 2008 only 94 deals involving Spanish entities were announced for an aggregate value of €20 billion, a decrease of nearly 40 per cent with respect to the same period in 2007.

Private equity investors enjoyed an excellent first half of 2007 and a very weak second half. Spain has experienced the same uncertainties as other economies in North America and Europe, with a significant slowdown in the real estate market and consumer spending. A limited access to financing has created serious difficulties for the leveraging of takeovers and other transactions in the high-end of the market, while the mid-market remains less affected. Sellers do not seem to be adapting to a new pricing reality and there appears to be a gap between vendors' expectations and new valuations from prospective purchasers. It seems safe to predict that there will now be a pause for thought in the private equity market.

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II GENERAL INTRODUCTION ON THE LEGISLATIVE M&A FRAMEWORK

The basic legal framework for corporate acquisitions in Spain consists of contract law and corporate law. For listed companies, the 1988 Stock Market Law and the regulations on takeovers through tender offers are also applicable.

Spanish contract law is mainly found in the 19th-century Civil and Commercial Codes. The 1989 Law on Corporations and 1995 Law on Limited Liability Companies govern corporate aspects that are relevant to the acquisition of these types of companies (the most common types in Spain). Mergers and other corporate reorganisations (spin-offs, contributions) are mainly governed by the 1989 Law on Corporations. The regulation of corporate reorganisations will most likely be amended in the near future, as explained in more detail in Section III, *infra*.

The 1988 Stock Market law, as last amended on 12 April and 19 December 2007, sets out the rules on public offerings, official listing of securities, transactions related to listed securities, takeovers and other provisions on listed companies. The Law is implemented by a number of regulations, including:

a the Regulation on Transparency Requirements Applicable to Listed Companies (Royal Decree 1362/2007), which implements Law 6/2007 and transposes Directive 2004/109/EC (as last amended by Directive 2008/22/EC) and Directive 2007/14/EC;

b the Takeover Regulation (Royal Decree 1066/2007) which also implements Law 6/2007 and transposes Directive 2004/25/EC;

c the Regulation on Market Abuse (Royal Decree 1333/2005, as amended on 16 March 2007, and developed by resolutions of the Spanish Securities and Exchange Commission ('CNMV') dated 19 December 2007), which transposed Directive 2003/6/EC;

d the Regulation on Official Listings and Public Offerings (Royal Decree 1310/2005), which transposed Directives 2001/34/EC and 2003/71/EC; and

e several other regulations, orders and instructions (available at www.cnmv.es) dealing with the information to be disclosed by listed companies and their shareholders, the clearing and settlement of market transactions, the annual corporate governance report to be filed with the CNMV, other regulated markets, investment services firms, etc.

Matters relating to tax, employment, antitrust issues, unfair competition, administrative and regulatory procedures, dispute resolution and other laws and regulations also form part of the M&A legal framework.

III DEVELOPMENTS IN CORPORATE AND TAKEOVER LAW AND THEIR IMPACT

The legal framework for M&A transactions in Spain underwent significant changes in 2007. These amendments mainly concerned takeovers (following the transposition of the Takeover Directive 2004/25/EC), but there were also changes to the Law on Corporations and to certain accounting rules, as well as to the merger control regime (which is dealt with separately in Section IX, *infra*). In addition, the regulation of the Spanish Companies Registry which develops the EU and Spanish legislation on the Societas Europaea has also been recently amended.

The takeover regime introduced by Law 6/2007 and Royal Decree 1066/2007 ('the Takeover Regulation'), greatly modified the takeover rules then in force. In contrast to the previous regime, the three key developments of this new Takeover Regulation are (i) the establishment of a mandatory *ex post* takeover bids system; (ii) the elimination of partial bids; and (iii) the introduction of the notion of 'equitable price'. Almost one year since its enactment, the Takeover Regulation deserves a favourable assessment on the whole, as it has modernised Spanish takeover rules and aligned the system with that prevailing in the rest of Europe. The regulations benefit from valuable past experience and should prove useful in the context of takeover bids.

Additional developments in 2007 affected the accounting rules provided in the Commercial Code and the Law on Corporations, as amended by Law 16/2007, Royal Decree 1514/2007 and Royal Decree 1515/2007 (in force as of 1 January 2008) to reflect International Financial Reporting Standards. In connection with this amendment, other accounting and corporate provisions (relating, *inter alia*, to treasury shares, share capital reductions and the distribution of profits and reserves) were also modified. Finally, the 1989 Law on Corporations and the 1995 Law on Limited Liability Companies have been amended with the purpose of significantly reducing the time frame of incorporation and registration of Spanish companies, especially limited liability companies.

In 2008, no significant amendments to the regulations affecting M&A transactions have yet been enacted. However, the government has submitted a highly relevant Bill to parliament to regulate structural modifications (mergers, spin-offs, etc.) of Spanish companies. The most relevant features of the Bill are the following:

a the Bill seeks to unify the rules on mergers, spin-offs, transformations, etc. in all kinds of Spanish commercial companies;

b provided that some information requirements are fulfilled, the Bill expressly authorises the merger of the leveraged acquisition vehicle into the target company. Merging is the most common mechanism to 'push down' the acquisition debt in LBOs in Spain, but according to the current regulations it is not absolutely clear whether such mergers infringe Spanish financial assistance rules;

c generally speaking, the legal requirements applicable to mergers, spin-offs, transformations, etc. are more flexible in the Bill than in the previous regulations;

d the Bill regulates EU cross-border mergers and international changes of corporate domicile.

The Spanish Ministry of Economy has also announced a global restructuring of the Spanish market regulators and supervisory authorities. At the moment, the three main pillars of the Spanish financial system are supervised by three separate authorities, namely the Bank of Spain (banks and financial institutions), the CNMV (capital markets) and the General Directorate of Insurance and Pension Funds (insurance).

The purpose of the proposed reform is to adopt the 'twin peaks' model, under which the CNMV and the General Directorate of Insurance and Pension Funds would disappear, their functions being split between the Bank of Spain and a newly formed entity called the National Financial Services Commission ('CNSF'): the Bank of Spain would supervise the soundness of all financial entities, while the CNSF would supervise financial markets' transparency and, in general, would protect consumer interests regarding financial products and services.

IV FOREIGN INVOLVEMENT IN M&A TRANSACTIONS

Over the last few years, Spanish corporations have been involved in a large number of significant cross-border deals in Europe (e.g., *Telefónica/O2*, *Sacyr/Eiffage*, *Ferrovial/BAA*, *Santander/Abbey*, *Iberdrola/Scottish Power*), North America (e.g., *BBVA/Compass Bancshares*, *Banco Santander/Sovereign*) and Latin America (e.g., *Telefonica/Colombian Telecom*, *Prisa/Chilean IARC*).

Although at a lower level than in 2006 and 2007, the first half of 2008 has borne witness to a number of relevant Spanish deals abroad:

a Grupo Planeta, a Spanish-based communications group, acquired French publishing house Editis SA from the listed French-based venture capital company Wendel Investissement for €1.02 billion;

b subject to regulatory approvals, Banco Santander has disposed of Interbanca Spa, an Italian-based bank, to GE Commercial Finance, in an asset-swap transaction for approximately €1 billion, which will enable Banco Santander to continue the consolidation of Santander Consumer Finance; and

c BBVA disposed of a 5 per cent stake of ordinary shares representing 2.5 per cent of the capital of Banco Bradesco (a listed Brazilian-based banking group) to Cidade de Deus Companhia Comercial de Participaçoes and Fundaçao Bradesco (a Brazilian-based holding company) for €976 million.

2008 has not been as active as 2006 and 2007 in terms of inbound investments. Notwithstanding, there have been some relevant M&A transactions involving foreign corporations investing in Spain, namely: Deutsche Bank AG and a group of international institutional investors agreed to acquire a 25 per cent stake in CLH, a listed Spanish company engaged in transportation and storage of oil products, from Enbridge Inc, a Canadian-based provider of natural gas and crude oil transportation services, for €876 million. We also saw the completion of the €3.9 billion acquisition of Aguas de Barcelona, which was announced last year when Hisusa, controlled by Suez Environment holding 51 per cent and Caixa Holding with 49 per cent, announced a tender offer for the remaining outstanding share capital of Aguas de Barcelona.

V SIGNIFICANT TRANSACTIONS, KEY DEVELOPMENTS AND HOT INDUSTRIES

In January 2008, Altadis, the Spanish-listed tobacco producer, was acquired by Imperial Tobacco for approximately €16.2 billion, creating Europe's second-biggest tobacco company after Philip Morris. The deal took longer than originally expected, partly due to the changes in Spanish takeover rules introduced in August 2007 and also because of the increased interest from private equity houses, namely CVC. Imperial's initial offer of €45 per share was rejected, as was its subsequent offer of €47. Altadis set the minimum bid at €50 per share and, after lengthy negotiations, Imperial Tobacco eventually agreed to the price. Later in the year, following the acquisition of Altadis by Imperial Tobacco, the latter launched a mandatory waterfall bid of €939 million for the entire outstanding share capital of Compañía de Distribución Integral Logista, Altadis's logistics subsidiary.

In November 2007, Banco Santander announced an agreement with Monte dei Paschi di Siena, the world's oldest bank, for the sale of Banca Antonveneta for a total of €9 billion. The transaction was not completed until May 2008 as the Italian regulatory authority required Banca Monte dei Paschi di Siena to sell between 110 and 125 branches to complete this purchase. Santander received Banca Antonveneta as one of the businesses that ABN AMRO allocated to Banco Santander as part of the carve-up of ABN AMRO following its acquisition by the consortium comprising Banco Santander, Royal Bank of Scotland and Fortis.

In a time of uncertainty and economic downturn, 2008 seems to be a year of acquisitions and expansion for Criteria Caixacorp ('Criteria'), the listed investment vehicle of the Spanish savings bank La Caixa. Criteria appears to have found a world of opportunities in what is clearly a buyer's market, given the current climate. In the first months of 2008, it committed over €3 billion to takeover bids and acquisitions. In addition to the joint takeover bid with Suez for Aguas de Barcelona (see Section IV, *supra*), in May 2008 Criteria announced that it had reached an agreement to acquire a 20 per cent stake in Inbursa, the financial services group controlled by Mexican billionaire Carlos Slim, in a deal worth approximately €1.5 billion, subject to the approval of the board and shareholders of Inbursa and the Spanish and Mexican regulatory authorities. The Mexican purchase was the second deal announced by Criteria in the same week, as Criteria is also part of a consortium led by Abertis (its related infrastructure group) and a Citi fund, which broke US infrastructure records with a winning US$12.8 billion bid on the 75-year lease of the Pennsylvania Turnpike, one of the largest public-private partnership initiatives undertaken in the United States.

In December 2007, a listed Spanish communications and publishing group, Prisa, offered to acquire the remaining stake it did not already own in Sogecable, a Spanish-listed media company, for €1.9 billion. The transaction was completed in May 2008, with the result that Prisa owns more than 95 per cent of Sogecable.

Air transport (including the failed sale of Spanair and continued rumours concerning Iberia), tourism, leisure, health care (including for the elderly), media and renewable energies all seem 'hot' industries, attracting significant interest from both strategic and private equity buyers.

VI FINANCING OF M&A: MAIN SOURCES AND DEVELOPMENTS

The noteworthy economic slowdown in 2008 is clearly affecting the financing of M&A. The global credit crunch and the burst of the real estate bubble in Spain are forcing banks to give careful analysis to their investment options. Thus, the number of closed acquisition finance transactions has decreased and the terms and conditions offered to the borrowers have become tougher in comparison with previous years.

During the second quarter of 2008, several Spanish companies have refinanced, looking for extended repayment terms, even at the price of higher interest rates, tighter covenants or additional security interest. Other companies are agreeing global out-of-court rescue plans to avoid insolvency, normally consisting of modifications to extend the term of their existing financing agreements.

Although covenant-lite loans were never popular in Spain, bank covenants have been tightened and security packages have been reinforced. In addition, the banks seem ever more concerned about theoretical insolvency scenarios. Apart from that general trend, the main features of the acquisition financings during 2007/2008 are as follows:

a despite their tougher terms, a wide range of financing products continue to be available for the borrowers: senior, second-lien, mezzanine, PIK and equity-like facilities. However, unlike other jurisdictions, such as the United States and the United Kingdom, debt security instruments are not commonly used to finance acquisition deals since limited liability companies (*sociedades de responsabilidad limitada*, which are the most commonly used vehicles for these transactions) cannot issue or guarantee debt instruments. Ancillary facilities are not very common, and bridge equity facilities have seldom been used in Spain. Staple financing is also used in some cases but has not been very successful in view of the fact that the staple finance provider is usually an easy target to beat by other banks;

b banks are increasingly reluctant to agree on the certainty of funds in their commitment letters. On the other hand, 'MAC' clauses and the 'diligence out' provisions are currently essential in commitment letters. Limits to changes in pricing that can be arranged without the borrower's consent have been widened under the 'market-flex' provisions, and 'reverse-flex' provisions have disappeared in the current situation;

c equity cures to financial covenants defaults are either no longer accepted or restricted to a limited number of cures during the lifetime of the financing. 'Mulligan clauses', which do not take into account breaches of financial covenants, are mostly ruled out;

d despite the material cost of stamp duty tax for the creation of certain security interests (mainly mortgages and chattel mortgages), banks are starting to require borrowers to create such security interests on the closing date instead of having a mere promissory mortgage. Promissory mortgages run the risk of being affected by the rules on claw-back and the restrictions on the disposal of assets in the Spanish insolvency regulations. Indeed, if the security interests were created within two years prior to the insolvency, they could be rescinded, as Spanish Insolvency Law considers securing an obligation that was initially unsecured to be detrimental to the bankruptcy estate of the debtor; and

e the use of Spanish law to govern acquisition finance documentation has become the norm, and only very large transactions that need to be syndicated throughout Europe are subject to English law. Only time will tell if the current liquidity crisis will foster an increasing use of English law for financings of M&A in Spain. In any event, transactions governed by English law require significant input from Spanish lawyers in many critical areas, such as corporate law (e.g., financial assistance rules, corporate benefit), insolvency regulations, security packages and access to expedited enforcement procedures, among others.

VII EMPLOYMENT LAW

Spanish regulations concerning the information and consultation rights of union representatives have been amended by Law 38/2007, in order to implement EU Directive 2002/14/EC, which establishes a general framework for such information rights.

Pursuant to Spanish provisions implementing EU Council Directive 2001/23/EC (the TUPE Directive), in the event of transfers of undertakings, the transferor and the transferee are obliged to provide certain information to union representatives involved in the transfer. Likewise, they are obliged to consult union representatives regarding the transfer if they intend to adopt labour measures affecting employees (e.g., change of work centre, substantial change of employment conditions, redundancies).

To date, Spanish case law has unanimously considered that transactions consisting of the acquisition of a majority stake in a company (i.e., share deals as opposed to asset deals) should not qualify as a transfer of undertakings, given that they do not trigger a change of employer. Therefore, they were not subject to the above-mentioned information and consultation obligations owed to union representatives. Although it is not expressly established in the above Law, scholars now consider that, in view of the new regulations, companies will also be obliged to inform union representatives (who are also entitled to issue a report) about share deals, particularly if the company is expected to downsize as a result of, or in connection with, the transaction.

VIII TAX LAW

During 2007 and 2008 there have been a number of developments in the Spanish tax and accounting legislation that affect M&A transactions:

a new transfer pricing regulations entered into force on 1 January 2007, establishing the obligation to apply fair market value to related-party transactions. This is in line with the accounting rules that require valuation at arm's length and reclassification of any difference between the agreed price and the market value according to the real and effective nature of income arising. The reporting and documentation obligations will be developed by a Royal Decree to be approved in the coming months;

b the new accounting rules establish new valuation rules for M&A transactions, based on the acquisition method, by which assets and liabilities acquired must be valued at fair market value. The positive difference between the value assigned to the assets and liabilities and the cost of the business combinations will be considered financial goodwill. Special rules will apply to mergers, splits and contribution-in-kind when the transaction is made within the same group of companies;

c in October 2007, the European Commission initiated proceedings against the Spanish government relating to Article 12.5 of the Corporate Income Tax Law. This provision enables a Spanish company that acquires a participation in a foreign entity which meets the requirements to benefit from the Spanish participation exemption (set forth in Article 21 of the Corporate Income Tax Law) to consider the difference between the acquisition cost of the shares and their underlying book value (i.e., the equity of the foreign subsidiary), which may not be allocated to the assets of the non-resident company up to the limit of its fair market value, as financial goodwill deductible for Corporate Income Tax purposes over a 20-year period (i.e., up to 5 per cent per year). The Commission considers Article 12.5 to be a state aid and thus incompatible with Article 87 of the EC Treaty. There is no deadline for the Commission to issue a resolution and it is not expected to do so before September 2008.

IX COMPETITION LAW

The new Competition Law, which entered into force in September 2007, has been developed this year by Royal Decree 261/2008, which approves the Competition Regulation. Two chapters (and two annexes) of this Regulation contain some novelties and developments on merger control. The main novelties are as follows:

a specific rules for calculating market share and turnover thresholds for mandatory notification – the same general rules as EC Regulation 139/2004 are adopted, with specific provisions on the calculation of turnover in relation to credit or financial institutions, financial holding companies and insurance undertakings;

b explicit reference to the value of efficiencies used in the assessment carried out by the Competition Commission – it is clearly provided that these efficiencies must be invoked by the notifying parties and, further, which general characteristics are to be taken into consideration. The Regulation adopts European Court of Justice case law on this matter: efficiencies must be quantifiable, carried out in the short term, and consumers should benefit from them;

c the merger notification process – the new Regulation sets out the moment (depending on the type of agreements between the parties) from which a merger can be notified, the form and content of the filing, the manner in which defective or insufficient filings are to be rectified and the consequences of late filing or non-rectification. In addition, it adopts a pre-filing formula to clarify formal and substantive aspects of the transaction, prior to its formal notification, without suspending the procedure. Initial experiences using this pre-filing mechanism show significant benefits in terms of less bureaucracy and time-saving;

d mergers that may benefit from the abbreviated form of notification – the new Regulation increases the cases where the abbreviated form may be submitted by the notifying parties. The main criteria are low market shares of the parties involved and no horizontal or vertical overlaps or marginal activities of the parties in the Spanish market. The Regulation also contains a description of cases in which the Competition Commission may require the parties to file an ordinary notification form (i.e., complex definition of the affected markets, unclear market shares of the parties or markets with high barriers to entry);

e a procedure to request the lifting of the suspension of a merger before its final authorisation;

f details of the consultation procedures with the Competition Commission regarding thresholds prior to the submission of the notification – written and confidential procedure and type of content of the consultations;

g developments regarding procedural formalities – confidentiality of documents, rights of interested parties, access to the file or oral hearing; and *h* presentation of remedies by the parties – there are provisions on the possibility for the notifying parties to submit remedies to the Competition Commission to resolve potential obstacles to effective competition derived from the merger. These may be submitted with the filing or during any phase of the procedure, and the Competition Commission may test them in the market by requesting the opinion of competitors, clients or suppliers of the parties. The presentation of the remedies implies the extension of deadlines for the authorisation of the merger.

X FUTURE DEVELOPMENTS AND OUTLOOK

Following the credit crunch in summer 2007, Spanish involvement in M&A activity has declined significantly. Private equity take-outs have almost entirely vanished. Large private equity exits have also dried up as IPOs and secondary LBOs have been postponed until market conditions improve. Nevertheless, expectations in the mid-market and below remain relatively optimistic, with room for consolidation particularly in the leisure, health care and education sectors. We should also see some cross-border deals in Europe and Latin America led by Spanish and European corporations (particularly in infrastructure).

Market conditions could also affect the type of businesses sold as owners hold their top performers for later in the business cycle. The mood in the acquisition finance market has changed noticeably in recent months: even the most competitive and aggressive banks have become more cautious about acquisition financings, either due to specific targets, or to more general industry concerns.

The credit crunch will probably have a greater impact on the value of M&A deals rather than the actual number of transactions in Spain. The difficulties of raising bank financing will most likely lead to deals characterised by lower leverage, but not necessarily to a dramatic reduction of midcap deals.

The sector that has arguably suffered most from the credit crunch in Spain is real estate and related industries. After several years of a robust and liquid market and the rapid rise in property prices, the industry is now facing an uncertain future. Although Spanish banks have not been directly affected by the subprime mortgage crisis, the world's adverse financial situation and the rise in interest rates and excessive mortgage-backed indebtedness have brought an abrupt end to the industry's 'golden age'.

The reduction in the availability of financing may also lead to scenarios in which the bidder cannot raise enough debt to acquire 100 per cent of the target company. Investors may therefore explore other alternatives (less common in the recent 'golden years') such as co-investment schemes with other bidders and acquisition of minority or majority stakes with sellers retaining a significant stake in the target.

As regards private equity, the knock-on effect of this slowdown may result in distributions and investment activity being slower in 2008 than in recent years, and some private equity houses may suffer from excessive prices as a result of auctions and the obscurity in the debt market in recent years. However, we expect conditions to normalise in 2009. Moreover, with the current economic climate, where failing stock markets coexist with sizeable liquidity still being available to private equity managers, new opportunities, an increased demand for the mid market and more focused mandates, especially for funds willing to ensure the quality of their deals.