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PROTECTIONISM AND PATERNALISM AT THE UK TAKEOVER PANEL -- PART II

The Panel Holds Its Ground -- An Analysis of Some of the Key Proposals

To Our Clients and Friends:

Introduction -- The Panel Stands Firm

In late November 2010, we published an article on the policy statement of the UK Panel on Takeovers and Mergers (***Panel***) which set out the ground work for changes to the rules governing the conduct of public takeovers in the UK as embodied in the UK Code on Takeovers and Mergers (***Code***)[1]. Last week, the Panel published a public consultation paper (PCP 2011/1) which sets out the detailed proposed amendments to the Code[2] as trailed in our earlier article. In summary, notwithstanding an outcry from seasoned market participants (in particular the advisory community) on some of the proposed changes which are perceived as having a detrimental impact on the openness of the UK M&A market, disappointingly, the Panel has not shifted from its position as set out late last year on the fundamentals/principles of its new approach on key areas such as the 'put up shut up' (***PUSU***) regime and offeree protection arrangements. We examine below certain critical features of some of these proposed changes.

"Outing" Potential Offerors & The New PUSU Regime

There were a handful of changes trailed in the Panel's policy statement which drew much commentary and criticism from certain quarters. The Panel's proposals regarding the naming of potential offerors and introducing a strict PUSU regime featured high on this list. The drivers behind these package of changes include reducing the period of uncertainty and disruption to offeree companies prior to an announcement of a firm intention to make an offer, shielding offeree companies from the difficult decision of deciding whether to invoke the PUSU regime and encouraging confidentiality/ stopping leaks on the part of possible offerors by effectively imposing premature disclosure if they get this wrong . . . regardless of whether they were responsible for the leak! So how will the new regime work?

- ***Publicly naming potential offeror(s)*** -- The proposed changes require offeree companies to identify or name any potential offeror or offerors it is in talks with in the announcement which commences the offer period.

- ***Mandatory 28 day PUSU*** -- A mandatory PUSU period of 28 days will automatically commence from the date of this announcement unless an extension is agreed to by the offeree and each offeror. This means that unsolicited offerors will be subject to this short period of clarification and they will not be able to benefit from extensions to this 28 day period (if any) agreed to by the offeree with any other potential offerors. The result of this also means that there may be different PUSU deadlines applicable to different offerors (unless the offeree decides to agree to the same deadline for all). To assist market transparency, details of the different offerors and deadlines will be disclosed on the Panel's website.

- ***Extending the 28 day period*** -- As noted above, the offeree company is at liberty to approach the Panel to request an extension in relation to a particular offeror or offerors shortly before expiry of a deadline. The Panel may consent to an extension taking into account all relevant factors including the status of negotiations between the parties and the anticipated timetable for completion -- conscious as always that the company not be held in a period of uncertainty for too long. Extensions will have to be promptly announced to the market by the offeree company.

- ***When does mandatory PUSU period fall away?*** -- In order to redress some of the imbalance caused by the new regime, the Panel has now decided to disapply the mandatory 28 day period to a potential offeror, where another offeror announces a firm intention to make an offer for the company -- as the Panel takes the philosophical view that the offeree company is no longer in the "virtual bid" uncertain world if there has been a firm offer on the table. The proposed new rules do however require clarification by publicly identified potential offerors in the "later stages of the offer".[3]

- ***When does the PUSU regime not apply?*** -- The Panel has clarified that the PUSU regime will not apply where the offer period commences with an announcement by the offeree company that it is seeking one or more potential offerors in connection with a formal sale or auction process. The rationale for this is similar to the dispensation above -- in such cases, the Panel does not treat the offeree company as being in an uncertain "virtual bid" situation as it voluntarily put itself into play.

- ***Naming subsequent offerors*** -- If following the initial possible offer announcement, the offeree is subsequently approached or enters into talks with other potential offerors, it is not obligated to make an offer disclosing the existence of such new potential offerors unless (in accordance with current Code policy and rules), there is rumour or speculation about the new potential offerors. Further, if the offeree company voluntarily wishes to make a statement about the existence of a new potential offeror (prior to an announcement of a firm intention to make an offer by any other offeror(s)), it will be required to identify the new offeror in that announcement.

- ***No intention to bid statements*** -- In response to a PUSU deadline, the PCP sets out proposed changes to the rules where a potential offeror goes on to issue a statement of intention not to make an offer. These are largely consistent with the Panel's current approach to such statements -- in drawing distinctions between voluntary and mandatory "no intention to bid" statements and allowing for circumstances where the usual ban on re-launching or re-activating an offer following such a statement, can be set aside. For further information on the impact of these statements, please contact us.

Ban on Inducement Fee and Other Deal Protection Arrangements

One of the most controversial parts of the Panel's proposed changes is the new prohibition on virtually most of the key deal protection arrangements commonly sought by offerors when launching or considering launching an offer. The Panel has sought to push back firmly on the standard "packages" requested by offerors in circumstances where they believe offeree boards are too weak to resist and/or adequately negotiate.

- ***What has been banned?*** -- Any deal protection measure including inducement or break fees (even if the arrangement does not involve any cash payment); any implementation agreement of the type typically entered into by the offeror and offeree prior to an announcement of a firm intention to make an offer [NB: These are most often seen in the context of schemes of arrangements]; any other kind of arrangements entered into earlier in the process (e.g. exclusivity or no shop arrangements); arrangements seeking to limit the offeree company identifying the offeror. The scope of the prohibition is deliberately intended to catch all types of offer related arrangements, unless they fall within the limited permitted exceptions (see below) and catch arrangements entered into during an offer period or when one is in reasonable contemplation. The prohibition lies against the offeree company and all persons acting in concert with it.[4]

- ***So what is permitted?*** -- The Panel has recognized that some minimal comfort needs to be afforded to an offeror before it is willing to launch a bid, and accordingly, an offeree can agree to: (i) certain confidentiality commitments; (ii) no-solicit provisions in relation to employees, customers or suppliers; (iii) commitments to provide information solely for the purpose of obtaining regulatory or official consents or clearances; (iv) irrevocable commitments or lock-ups. By way of clarification, it is totally open for the offeror to agree to limit itself in any manner.

- ***Limited dispensations: White Knights/ auctions/ financial distress*** -- The Panel is proposing to provide a dispensation (following consultation) from the general prohibition in three limited circumstances. The first arises where following an unsolicited or hostile offer announcement, the offeree wishes to induce a "white knight", it is permitted to enter into an inducement fee arrangement (only) with one possible competing offeror. Second, if the offeree company has put itself up for sale by launching a formal auction process, it may be permitted to agree to an inducement fee or other offer-related arrangement with one offeror, at the time of announcement by the latter of a firm intention to make an offer. Third, the Panel will consider permitting the same if the offeree company is in serious financial distress. Whilst the first two dispensations will be codified, the third one will not be expressed in the Code. The Panel has also clarified that (as in line with the current rules) the inducement fee should be *de minimis* -- normally not more than 1% of the offer value

- ***Impact*** -- As discussed previously, these changes are likely to have an adverse impact on the ease and frequency of bids, particularly private equity or financial sponsor led bids (where the bidder is not the first in time recommended bidder). Even the *de minimis* inducement fee of 1% currently permitted under the Code, has been a real aid or inducement to offerors when deciding whether or not to launch a bid. Further, in the context of schemes of arrangement, where best practice has led to the development of comprehensive implementation agreements setting out the time line and obligations of the offeree and offeror companies (essential for the latter as schemes are essentially offeree-driven offers), this may have an additional negative impact on the offer price if potential offerors choose not to pursue a scheme and thereby forsake the potential stamp duty saving. The Panel has offered a limited concession on implementation agreements, proposing to permit offeree companies (provided they continue to recommend an offer) to agree to a timetable with the offeror companies -- this however is still significantly short of the substantive protections found in scheme implementation agreements today.

Coming to the Rescue of Directors of Offeree Companies

As noted in the PCP, one of the key drivers behind the change to the PUSU regime is to take away from directors of target companies the "difficult" decision of deciding whether and when to invoke the PUSU regime. Similarly, the proposed prohibition on deal protection measures is to relieve directors of target companies of the pressure of negotiating a reasonable inducement fee and other protective provisions in favour of bidders. These proposals appear, at one level, to fly in the face of current trends in raised standards of corporate governance, enhanced board responsibility and increased care in satisfying board fiduciary duties, as the Panel measures place effectively "cocoon" target directors from having to make decisions on key matters during the course of a bid . . . presumably, part of what they are remunerated for in the first place.

In a similar vein and consistent with the Panel's original position when it considered a host of possible changes to the Code, some of which required (in their view) a change in company law, the Panel has tried to avoid parallel regulation in the form of prescriptive factors that the board of a target company is required to consider in deciding whether to recommend an offer. However, the Panel has thought it necessary to lend a helping hand to directors of target companies by codifying its clarification that the Code does not dictate what factors the directors of target companies should consider and in particular notes that it does not state that the offer price should be the determining factor.

The Burden of Fees/Expenses Disclosure

When the Panel flagged its proposal to require disclosure of advisers' fees, the advisory committee knew that it would be pointless objecting to this push for enhanced transparency, having already been the "soft" target of much reform in the global securities industry in the wake of the financial crisis. In fact, as noted in the PCP, the majority of respondents to the Panel's policy statement were in favour of greater disclosure. What will the new rules mean in practice and what are the tricky issues?

- ***Scope*** -- The new rules require disclosure of all fees and expenses of both offeror and offeree companies expected to be incurred in connection with the offer including the following: (i) financial and corporate broking advice; (ii) financing arrangements; (iii) legal advice; (iv) accounting advice; (v) public relations advice; (vi) other professional services (e.g. management consultants, actuaries); and (vii) other costs and expenses. As can be seen the net has been cast so widely as to catch any form of fee or expense connected with an offer.

- ***What kind of details?*** -- Disclosure is required of the aggregate fees and separate disclosure of the items noted above. In relation to fees and expenses incurred by the offeror in funding the offer, whilst this will include up-front fees, draw-down fees etc (see below), the offeror will not be required to disclose fees or margins payable in connection with hedging arrangements as the Panel considers this more akin to internal treasury/housekeeping and strictly offer related.

- ***Fee estimates & getting it wrong*** -- One of the tricky issues on the new disclosure requirements relates to the need to provide estimates. If there are any fee arrangements which have an uncapped or variable element (e.g. dependent on value of the offer, time-cost, discretion of payer), the offeror or offeree (as applicable) will nonetheless be required to disclose either (i) the maximum and minimum amounts payable under the agreed formula; or (ii) provide an estimate of the fees likely to be paid. It is the latter which may well prove to be a challenging exercise in practice for parties -- an estimate on either the low or high side can be subsequently challenged as misleading. Further, an estimate on the low side which is subsequently "materially" exceeded, requires prompt disclosure to the Panel which will decide on the appropriate remedial course of action (which may include a public announcement -- not the kind of publicity generally favoured by parties or their advisers!). Unhelpfully, neither the text of the PCP nor the proposed changes provide any guidance on what is meant by "materially" exceeding an estimate.

Compelling Enhanced Transparency Upon Offerors

The PCP proposes much more extensive disclosure about offerors and offer financing arrangements. In particular:

- ***Key financials*** - All offerors will be required to disclose key financial information including last two audited consolidated accounts and a statement of the effect of full acceptance of the offer on its earnings and assets and liabilities. By way of concession having heeded the warnings of a number of leading accountancy firms, the Panel is no longer requiring the preparation and disclosure of pro-forma balance sheets of the combined group.

- ***Changes since the last accounts date*** - By way of concession, only offerors on share exchange offers need to undertake the burdensome additional disclosure of all known significant changes in its financial or trading position since its last published audited accounts

- ***Credit ratings*** - There is a new requirement for disclosure of details of all credit ratings and outlooks publicly accorded to offerors and changes to these ratings during the offer period prior to publication of the offer document. This onerous disclosure obligation strikes us at odds with the (reduced) weight and credence given to credit ratings in the light of the financial crisis at a global level. The obligation also applies in respect to ratings of offeree companies.

- ***Bid financing*** -- Detailed disclosure of the manner will be required about the offer financing arrangements including disclosure of the parties, all fees (commitment fees, up front fees, draw down fees etc), interest payments (including "step-up" variations), key covenants refinancing arrangements and timing constraints on repayment obligations. In recognition of possible commercial sensitivity, the Panel will not require disclosure of headroom in the offer financing facility; nor will it require detailed disclosure of the structures by which equity is provided to private equity offeror vehicles.

- ***Scope of application*** -- These rules (save where noted above) will apply to all UK incorporate offerors with shares admitted to trading on a UK regulated market, AIM, or PLUS on both cash and share exchange offers. The rules will also apply to all other offerors (e.g. foreign offerors) so far as appropriate.

"Coming Clean" on Plans for the Offeree

One of the much talked about set of proposals trailed in the Panel's policy statements were those relating to disclosure regarding the plans of the bidder for the target, its business and employees.

- ***Trading facilities*** -- One of the new content requirements is for an offeror to disclose its intentions with regard to the maintenance of existing trading facilities for the offeree company's relevant securities as this the Panel notes could well be an important factor for shareholders in making a decision on whether to accept an offer.

- ***Negative statements*** -- One of the key changes to the rules is the subtle but important shift in disclosure -- in addition to making substantive disclosures about (i) its intentions with regard to continued employment of employees and management of the offeree group including material changes to conditions; (ii) strategic plans for the offeree and likely repercussions on employment and places of business; (iii) intentions with regard to redeployment of assets; and (iv) the new requirement regarding intentions to maintain trading facilities, the offeror is required to make a positive statement if it has no intentions in respect of any of these matters.

- ***Holding Offerors (and Offerees) to statements*** -- The Panel had flagged its intention to follow up on promises made by offerors on their plans for the offeree for at least a 12 month period from the date the offer becomes wholly unconditional. The PCP has enhanced and clarified this new enforcement regime by making it clear that it will apply to any statement made by the offeror, at any time during the offer period and in any form of communiqué (documents, announcements etc) AND that it will also apply to statements made by the offeree company.

- ***How long do the statements need to hold true? And what happens if they don't?*** -- The Panel has made it clear that if the statements themselves set out a time frame for fulfillment, it will be this stated time period which is relevant. However, in the absence of a stated time period, the 12 month rule noted above will apply. If action is taken contrary to the statements made within the relevant time period and the Panel is not satisfied that it was a reasonable statement to have been made at the time, it will instigate disciplinary action[5] against the defaulting party.

Giving Employee Representatives a Helping Hand

The Panel has demonstrated a real desire to be seen to be providing employee representatives and employees with as much visibility whilst the offeree company is in play.

- ***Who are employee representatives?*** - The first element of the proposed changes is to clarify who are the "employee representatives" of a company -- it is now clear that this concept extends beyond the person(s) formally appointed in this role[6] but also to representatives of any trade union which has been recognized by the offeror or offeree company (as applicable).

- ***It's ok to talk . . .*** - The Code will be amended to make it clear that notwithstanding the comprehensive rules on secrecy (prior to announcement of an offer), offerors and offerees are permitted to have confidential discussions with employee representatives and to pass them information.

- ***Speeding up disclosure*** - In a bid to enhance information rights to employees, the Panel is proposing that employees should have similar rights as shareholders in a company -- they too will be entitled to be informed about the offer at the time of a possible offer announcement and will no longer have to wait until the announcement of a firm intention of an offer.

- ***Employee Representative opinions: costs & publishing obligations -*** In addition, at this time, employee representatives will have to be reminded of their rights under the Code to have their opinions on the offer appended to the offeree board's circular if it is received in good time prior to the publication of the circular. In practice, this obligation is likely to be fulfilled through the usual communication channels in organizations (e.g. internal emails) during which time the company will direct the employees or the representatives to where they can access the relevant offer announcements and remind them of their rights. In a new proposed change to the Code, not previously flagged in the Panel's policy statement of 2010, the Panel is proposing that even if the employee opinion is not received "in good time", the offeree board is obliged to publish it on their website and to publicly announce the publication of the opinion by way of announcement on a regulatory information service (RIS). Whilst this will only result in relatively small incremental cost to the company, of greater impact (although the Panel do not consider it to be of disproportionate significance) is the new requirement that the offeree company must fund the "costs reasonably incurred" by the employee representatives in obtaining any advice required for the verification of their opinion. Not surprisingly, no guidance is provided as to what "reasonable" costs are -- does the Panel really want to be the arbiter on this issue?

What Else & When Does the Market Get Hit?

The Code Committee of the Panel took the opportunity of proposing other "tidying up" and minor changes to the Code. For further information about these, please contact us.

The consultation period ends on Friday, 27 May 2011. Following initial consideration of the responses, the Panel will notify the public of the likely timeline for implementation and thereafter a Response Statement will follow containing the final text of the changes to the Code. It is likely that the changes will take effect with almost immediate effect following publication of the Response Statement as the nature of the majority of the proposed changes do not merit a lengthy transition time, in particular, no fundamental systems changes will be necessitated by market participants. Accordingly, we expect the changes to take effect late summer this year.

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[1] Protectionism and Paternalism at the UK Panel on Takeovers and Mergers

[2] http://www.thetakeoverpanel.org.uk/consultation/current-consultations

[3] This has typically been on or around 10 days prior to the end of the 60 day offer timetable, sometimes referred to as "Day 50" notwithstanding the actual date may be earlier or later than the 50th day of that offer

[4] Note: Pursuant to the Definitions in the Code, this would be presumed to include the offeree company directors

[5] The disciplinary "tool kit" of the Panel includes the power to privately (verbally or in writing) and publicly censure, formally report the offender to relevant regulatory authorities or "could shoulder" the party

[6] In most cases this would have been pursuant to the EU Directive implemented in the UK in the Information and Consultation Employee Regulations 2004

Gibson, Dunn & Crutcher lawyers are available to assist in addressing any questions you may have about these developments. Please contact the Gibson Dunn lawyer with whom you work, or any of the following lawyers in the firm's London office:

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