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Review of the UK Takeover Code

At the beginning of this month, the UK Panel on Takeovers and Mergers (the **Panel**) announced a wide-ranging review of a number of fundamental principles of UK takeover regulation contained in the Panel's City Code on Takeovers and Mergers (the **Code**). Responses are required by 27 July 2010. This review has been prompted in part by the debate - both in the press and among politicians - generated by the highly controversial and ultimately successful bid by Kraft for Cadbury earlier this year. Cadbury is a long standing client of Shearman & Sterling and the firm acted as US counsel to Cadbury in this battle. This briefing looks at the review and notes some issues raised by it, in relation to which positions adopted in France, Germany or Italy may be instructive.

Key points

- The Panel is consulting on **nine principal issues**
- Most controversial are a possible:
 - **raising of the minimum voting rights acceptance condition** from 50% plus one, and
 - **“disenfranchisement” of voting securities** acquired in the target during an offer period.
- Other issues include possible:
 - **greater disclosure in offer documents** (including with respect to advisory fees)
 - **disclosure of offer acceptance/scheme voting intentions**
 - **tightening up of some Code rules** (e.g. the so-called “put up or shut up” rule or rules permitting payment of inducement fees in recommended bids or other deal protection measures), and
 - **shortening of the Code timetable.**

UK and other EU takeover regimes

Following the implementation of the EU Takeover Directive (the **Takeover Directive**), the Panel's ability to change the provisions contained in the Code is now constrained by the requirement that its rules give effect to certain key articles of the Takeover Directive; in particular article 3 which sets out six general principles with respect to the regulation of takeover bids in the EU. These principles are set out in the Code and provide the basis for the 38 detailed rules that make up the rest of the Code.

As discussed below, in its consultation document, the Panel's Code Committee acknowledges that certain of the possible changes to the Code on which it is consulting might raise issues with respect to the Takeover Directive.

The existence of the Takeover Directive does not mean, however, that each EU member state's domestic takeover regime is identical. This briefing identifies a number of different positions that are adopted by the takeover regimes in **France, Germany and Italy** on some of the issues raised by the Panel's consultation.

Further advice on those positions can be obtained from Shearman & Sterling's offices in those countries, details of which can be found at the end of this briefing.

The current Code review

A copy of the consultation can be accessed by [clicking here](#). It is important to note that, unlike the usual consultation exercises that the Panel undertakes with respect to the Code, in this case the Panel has not reached any decision with respect to whether, and if so which, changes should be made to the Code. It has therefore not provided any proposed rule changes to the Code and stresses that it retains an open mind on the issues on which it is consulting.

This consultation follows on from two recent important sets of rule changes under the Code: a relaxation of the restrictions on the bidder acquiring securities in the target (under rule 5 of the Code) and revised disclosure obligations with respect to holdings in, and acquisitions of, certain target and bidder securities; as well as a recently closed consultation on proposed changes to the Code's rules on the use of profit forecasts and asset valuations in bids.

Interestingly enough, when making the recent rule 5 change, the Panel said that it intended to consult on whether a much more radical relaxation or removal of the restrictions under rule 5 should be introduced. However, perhaps not surprisingly in a document that considers more extensive regulation of takeovers in the UK, there is no further word about a possible relaxation of rule 5 in the current consultation.

Removing short-termism from UK bids?

An issue that the Cadbury takeover highlighted was the increasing tendency for short term investors, particularly hedge funds, to buy into a target's stock during the course of a bid and consequently end up having a decisive say in the bid's success or failure. In the case of Cadbury, it was reported that by the time Kraft succeeded in obtaining Cadbury's

recommendation, more than a quarter of Cadbury's shares were in the hands of hedge funds.

This has prompted the Panel to raise for discussion two issues:

- whether the minimum level of acceptances allowed for bids under the Code should be raised from 50% plus one of voting rights, to (say) 60% or two-thirds, and
- whether there should be excluded from acceptances of an offer that count towards the acceptance condition, those shares (or rather, the voting rights attaching to shares) that have only been acquired by the accepting shareholder during the course of the bid.

As with all of the issues covered by the consultation, the Panel sets out arguments for and against making any change to the existing rules under the Code in this area. It also indicates where it thinks that changes could be implemented simply by amendments to the Code and where other regulatory changes (including changes to basic company law) may be required, involving other regulators or the Government.

Raising the acceptance condition above 50% plus one

The proponents of this change argue that increasing the majority of shareholders required to accept a bid in order for it to succeed should help increase the influence of long term shareholders in the target. They can also point to the 75% of votes requirement (on top of a majority in number of shareholders) for schemes of arrangement under the UK's Companies Act 2006. These court-sanctioned schemes involving the target and its shareholders are commonly used to implement takeovers in the UK because of the binding effect such schemes have on all shareholders (whether or not the shareholders voted in favour of the scheme or even attended the scheme meeting), as well as the stamp duty savings benefits they can have.

This scheme-based argument, however, is weakened by the fact that the 75% requirement can be (and often is) satisfied by considerably less than 75% of the entire voting rights in the target, since the requirement only relates to the voting rights represented at the relevant scheme meeting.

There are strong arguments against making this sort of change which have been widely aired in the UK financial press. The most obvious is the fact that with 50% plus one vote, the offeror will have acquired legal, as well as de facto, control of the target by virtue of its ability to pass ordinary resolutions (including resolutions to remove and appoint directors to the target's board). A mismatch between the Code's acceptance condition and this basic company law rule would certainly be undesirable and so any change to the acceptance condition may be expected to involve a corresponding change to the ordinary resolution requirements under company law, which is something that no one has seriously suggested is either required or desirable.

Of course, the position of the target's board would also be very difficult if a bid failed through not receiving a new super-majority required under an amended Code, even though it had received majority support. Philosophically, many have also argued that the Code should not seek to differentiate between the merits and relevant importance of short term and long term shareholders.

In this respect, the UK seems to be tightening up a requirement that is not regarded as important in some other EU member states. In **France, Germany** and **Italy** no minimum acceptance conditions are required. Moreover, in **France**, the Panel's equivalent, the AMF (Autorité des Marchés Financiers), does not generally allow an acceptance condition that exceeds two-thirds of the target's shares and is sometimes reluctant to accept a condition that exceeds a simple majority of the target's shares.

Disenfranchising shares acquired during the offer

The possibility of disenfranchising (and so excluding from the voting rights required to be obtained in order for a takeover bid to become unconditional as to acceptances) shares that are acquired once an offer period has started, seems to raise even greater problems and issues.

There are a large number of potential problems with such a change and the consultation notes many of the arguments that could be made against it; so many, in fact, that it seems very unlikely that it would (or could) be proceeded with any time soon. These include:

- the ease with which any such disenfranchisement could be avoided (and the near impossibility of trying to monitor and enforce this rule) by non-record (i.e. beneficial only) changes of ownership
- the possibility that discriminating against such short term shareholders offends the general principle of equality of treatment for all target shareholders and so would not be compliant with the Takeover Directive
- the possibility that the decision as to the success or failure of a bid could end up resting with an ever decreasing group of target shareholders as target shares were traded during the offer period
- the downward pressure this could place on the price at which offers could succeed, if new shareholders were denied any influence over the bid thereby impacting demand for the target's shares and so leading to a higher perceived bid premium and less pressure on the offeror to increase its bid
- if this "disenfranchisement" were to extend to takeovers implemented by schemes of arrangement, as logically it should do, changes in company law would be required, including consideration of whether any other target shareholder resolutions required during the offer period should be affected by the disenfranchisement

- how the disenfranchisement would work with the acceptance condition – if the decision on the bid lay with the long term shareholders who could not deliver to the offeror majority legal control of the target, what should happen?
- the treatment of existing shareholders who sell and then buy further shares during the bid, and
- the impact this change could have on the disclosure regime that operates under the Code, one of the features of which is the obligation to disclose interests of 1% or more in shares carrying voting rights – how could these disclosures be sensibly made when the total voting rights position would be constantly changing with each trade in the target's shares.

Interestingly enough, despite general concerns about a variety of short-term practices in equity markets in the EU, none of **France**, **Germany** or **Italy** have introduced disenfranchisement sanctions or qualifications in the context of public takeovers. That is not to say, however, that no distinction is ever drawn between longer term and short term investors: in **France**, for example, the articles of association of companies may provide for double voting rights for shareholders who have held their holdings in registered form for at least two years (or whatever longer period is provided in the articles). While these enhanced voting rights are lost on the shares being tendered to an offeror, the French position nevertheless shows that the possibility of conferring a greater say on those investors who have demonstrated a greater (or at least longer) commitment to investment in a company is not unheard of in Europe.

Translating that general principle into a means of takeover control and regulation seems, however, to be a much more difficult concept to contemplate. The French position is, however, relevant to the consultation's broader enquiry as to whether, even outside of an offer period, voting rights should have to be "earned" by a minimum period of ownership. Of course, whether such a general question is one that the

Panel should be raising or even considering is a different matter.

Increased disclosure in takeover offers

The consultation also discusses some rather less fundamental or controversial changes to the Code, including whether there should be greater disclosure in takeover bids in certain areas, such as:

- reducing the threshold level for disclosure of interests in relevant voting securities of the target and paper offerors, from the current 1% to 0.5% - no compelling arguments are produced for this and, what is more, the disclosure regime was itself significantly revised as recently as April 2010.

In this connection, it is worth noting that in **France** the AMF raised a comparable disclosure threshold with respect to the target's securities from 0.5% to 1% in July 2009. Once a 2% threshold is exceeded, the AMF requires disclosure of the acquirer's intentions with respect to the outstanding offer for the target (i.e. whether it intends to continue to acquire target shares or ultimately to tender its holdings in the offer). Interestingly enough, the Panel's consultation includes the question of whether in the UK there should be greater disclosure about acceptance (or for schemes, voting) intentions in relation to offers. There would clearly be some French precedent for such requirement, although since even under AMF rules such disclosures do not preclude a change of investment strategy by the relevant shareholder (provided it is duly announced to the market), it may be questioned how useful, ultimately, such disclosures would be, whether or not, as a matter of principle, they are considered desirable

- increased disclosure of information by the offeror about the financing of its bid and by the target about its views on the offeror's future plans for the target, beyond what is already required by the Code, including where the offeror is simply a cash offeror – again, the arguments for increased

disclosure about the offeror's financing of its bid do not seem very obvious or compelling; we can, however, see some consistency between increased disclosure of the target board's views on the offeror's plans in director's and the board's duties to stakeholders such as employees and the wider community.

- whether targets should be required to obtain for the benefit of their shareholders similar independent advice on the offer to that which the Code currently requires a board to obtain for itself and to disclose in its response to the offer. The consultation notes the difficulties that any financial adviser would face in giving such advice to a shareholder body about which it would know very little and that very few, if any, jurisdictions require such advice, specifically addressed to the target's shareholders, to be obtained.

Even in the **US**, where obtaining fairness opinions is common practice, such opinions are not addressed to stockholders. They do, however, commonly disclose much greater detail about the financial analysis underlying the opinion than is the practice, influenced by the Code's profit forecast rules, in the UK.

In **France**, the AMF requires an independent appraiser's fairness opinion to be obtained by the target (and addressed to the board and disclosed in full to the target's shareholders) in certain cases, including where there is a potential conflict of interest within the target's board. The independent appraiser is not allowed to be paid any success fee (i.e. a fee dependant on the success of the offer or the successful bid value of the target), and

- possible disclosure of details of advisory fees.

Inducement fees and deal protection

The Code already contains some basic restrictions with respect to inducement fees payable by a target to an offeror:

- normally they must be limited to no more than 1% of the target's offer value
- the target and its financial adviser must confirm to the Panel that they believe the fee to be in the best interests of the target's shareholders
- the fee has to be disclosed in the offer document, and
- the Panel must be consulted as soon as possible if a fee is proposed.

Nevertheless, perhaps prompted by the regularity with which recommended offers now include such fees and a feeling that insufficient regard is being given as to their real value to shareholders and to ensuring that the deal goes through, the consultation invites views as to whether inducement fees should be subject to greater control or even outright prohibition. This is, of course, a very topical concern and many would say a worthwhile area for the Panel's Code Committee to be consulting on.

Again, the position in **France** is of interest in this area. Inducement fees have been included in some recent offers and have so far been accepted by the AMF. However, influenced by the 2% minimum increase for any competing bids that the AMF requires, these fees have not exceeded 2% of the offeror's bid value for the target and so far have not been subject to review by the French courts. Under the French Civil Code, the courts would be likely to have power to reduce these fees if they determined that they were excessive in relation to the damages actually suffered by the offeror.

The Panel is also inviting views on other "deal protection" provisions commonly included in implementation agreements between the target and offeror, such as "no shop" provisions and various attempts to tie the hands of (or at least delay) the target board with respect to recommending other offers by requiring notification to the offeror of other unsolicited approaches, etc.

It will be very interesting to see whether, as a result of this consultation, the Panel proposes to outlaw or

further restrict in UK takeover bids these increasingly common deal protection terms.

Put up or shut up

One of the key general principles underlying the Code is that a target should not be hindered in the conduct of its affairs for longer than is reasonable by a bid. In recognition of this and to address the distracting uncertainty that a target can face when it receives a bid approach that does not amount to a firm offer but merely an unsolicited “bear hug” or proposed combination, a new rule was introduced to the Code in 2004.

This rule allows a target to ask the Panel, at any time following the announcement of a possible offer and before announcement of a firm intention to make an offer, to set a deadline by which the would-be offeror must either make a firm offer or state that it will not make an offer. In the latter case, the Code will generally preclude it from announcing any other offer for the target for the next six months.

Since the introduction of this rule, there have been over 60 “put up or shut up” rulings given, 36% of which have led to an offer being made. The Panel usually sets a six to eight week deadline under this rule. In the Kraft/Cadbury bid, on 30 September 2009 the Panel set a 9 November 2009 deadline for Kraft to announce a firm offer for Cadbury.

The Panel is consulting on whether the deadline under this rule should be standardised, whether it should be automatic once a possible offer has been announced and whether “private” put up/shut ups should be allowed where the possible offeror has not yet been publicly named. In this connection, it is worth noting that there is no set deadline laid down by the AMF in **France** in relation to its similar “put up or shut up” rules and its decisions are reached very much on a case by case basis.

Related to this issue is the question of whether the Code should continue to allow possible offers to be

announced subject to pre-conditions and whether the offer timetable set out in the Code should be shortened. It has to be said that to date there does not seem to have been very much pressure for a tightening up of the Code’s rules in these areas although it should be noted that in **Germany** no pre-conditional offer announcements are permitted at all. The Panel would therefore have some precedent for tightening up the Code rules in this area if it chose to go down that particular path.

Other issues

The consultation also rather surprisingly raises the issue of the re-introduction of a set of rules that was only abolished in 2006. These rules – the so-called Substantial Acquisitions of Shares Rules – restricted the speed with which bidders could engage in dawn raids to acquire near-controlling (in Code terms, 30%) voting rights stakes in targets. The consultation itself notes that there does not seem to be any evidence that market raids have increased since the rules’ abolition.

Of course, the EU Transparency Directive already requires certain shareholding disclosures in respect of the acquisition of voting shares that are admitted to trading on regulated markets. Disclosures are triggered by holdings which pass through 5%, 10%, 15%, 20%, 25%, etc. As with some other EU member states, in the UK lower thresholds apply with respect to UK listed companies.

In **France**, crossing each of the 10 to 25% thresholds triggers an obligation to declare to the AMF (and the market) the objectives that the acquirer intends to pursue for the next six months, including whether or not it intends to make further acquisitions in the market, to seek control of the company or representation on its board of directors or its supervisory board. While this is not a restriction as such on a potential offeror moving towards a one-third controlling interest in the target’s equity capital (at which level, under AMF rules, a mandatory bid for all

the remaining equity and certain other financial instruments is required), it is clearly designed to highlight potential offerors and to force a degree of clarity and openness in the market with respect to their intentions.

In **Germany** disclosures are already triggered by holdings which reach or pass through 3%. In addition, comparable to **France**, a shareholder reaching or passing through the 10% threshold, unless exempted from this requirement by the company's articles of association, has to disclose whether it (i) has strategic intentions with respect to its investment, (ii) intends to acquire additional voting rights within the next twelve months, (iii) intends to influence the composition of the company's management or supervisory board, and (iv) is aiming at a significant change of the company's capital structure.

In **Italy**, there is no separate requirement for this sort of strategic intentions disclosure. However, CONSOB, the Italian Financial Regulatory Authority, has general statutory power to require market participants, which includes holders of more than 2% of a listed company's voting shares, to disclose material information to the market, including, as has happened in several instances, statements on their strategic intentions with respect to Italian issuers

The Code Committee also, in very general terms, invites views on whether shareholders in offerors should be given similar protections to those enjoyed by a target's shareholders. As already indicated with some of the other questions raised by the consultation, it seems far from obvious that there is a pressing need for change in this area and there are a number of issues – including how you would deal with non-UK incorporated offerors

– that would undoubtedly complicate any attempt to impose such changes on takeover bids in the UK.

Next steps

When the Code Committee has reviewed the responses it receives to the consultation, it will decide whether any amendments to the Code rules are required and, if the answer is yes, it will issue further consultation papers with proposed rule changes. In those areas where the Panel decides any change falls within the responsibility of another regulator or the Government, it will make available to the regulator concerned or Government the results of its consultation.

The opportunity which this consultation provides to debate some pretty fundamental principles of UK takeover regulation and practice, as well as possible extensions of some existing Code rules, is to be welcomed; even if it must be unlikely that this will lead to many, if any, of the more fundamental changes to the rules that the consultation covers, being made in the near future. Some of those changes may appear to suggest that the UK regime leaves targets too exposed to hostile approaches. However, there is clearly no suggestion of any change to the longstanding Code rule (now buttressed by the Takeover Directive) against poison pills and the sorts of defensive measures that in the **US** have a much bigger influence on the success of hostile bids than any of the changes now being canvassed in the UK would have.

With respect to the rest of Europe, there are clearly a number of different approaches, particularly in **France**, that the Panel may want to consider further before deciding which, if any, of the changes on which it is consulting, it should proceed with.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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