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UK Takeover Panel publishes draft rule changes to the Takeover Code

On 21 March 2011 the UK Panel on Takeovers and Mergers (the Panel) published its long awaited draft changes to the rules of the Takeover Code (the Code) which are proposed to implement the changes that were announced by the Panel in October 2010. Those changes were announced following a consultation and review that took place during mid-to late 2010 in the aftermath of Kraft Foods' ultimately successful takeover battle for Cadbury and the ensuing political fallout. The draft rule changes largely follow the proposals announced in October 2010, although the Panel has introduced some important clarificatory modifications. Notably, modifications apply in relation to the provisions that will require offerors to be identified and to clarify their intentions within a short period of time of a possible offer being announced. There are also some modifications affecting the proposed ban on target companies from agreeing to inducement fees and other deal protection mechanisms.

Background

In its earlier review, the Panel expressed concern that market practice now favoured offerors to the detriment of target company shareholders—in particular, that hostile offerors have, in recent times, been able to obtain a tactical advantage over a target company. It therefore proposed rule changes to address this concern with a view to restoring the balance in favour of target companies. The Panel also suggested changes to the Code in order to improve the offer process and to take more account of stakeholders that are not target shareholders (such as employees). A copy of our client publication about the October 2010 proposals is available at: http://www.shearman.com/files/Publication/aeec964a-ae34-4983-b60b-d23075d4eb0b/Presentation/PublicationAttachment/7df76ce3-c372-44a8-a946-7ec9fa6dc7c3/EC-102610-Update-on-the-UK-Takeover-Panel.pdf

Key points

As previously announced, the draft rule changes involve:

- Shortening the “virtual bid” period during which target companies can find themselves under virtual siege by a rumoured or potential offeror which has not yet announced a firm intention to make an offer.
- Strengthening the position of target companies, particularly with respect to the now common demands by “recommended” offerors for extensive US-style deal protection measures (such as inducement fees (currently limited by the Code to 1% of the value of the target company based on the offeror’s bid price and soon to be outlawed altogether) and no-shop or matching rights provisions).
- Increasing transparency and quality of disclosure in offer documentation (e.g. in relation to adviser fees and offeror financial information even in the case of cash offers).
- Providing greater recognition in the bid process of the interests of the employees of target companies.

The two most significant rule changes being made by the Panel (i.e. the two mentioned first above) will not apply in the context of a formal auction by the target.

Key changes or clarifications from the Panel’s October 2010 proposals

- The new rule requiring offerors to be named in announcements of possible or potential offers will not require potential offerors to be named where the announcement is made after another offeror has announced a firm intention to make an offer for the target. However, such offerors will have to clarify their intentions with respect to making an offer at a later stage in the offer period decided by the Panel.
- Potential offerors who are already subject to “put up or shut up” deadlines (by which, under the Code, they have to announce a firm intention to make an offer for the target or to announce that they will not be making an offer for the target), will be released from these deadlines (and any further potential offerors will not be subject to them). This will only apply once an announcement of a firm intention to make an offer has been made by another offeror. However, such offerors will have to clarify their intentions with respect to making an offer at a later stage in the offer period decided by the Panel.
- As well as not applying to targets which have announced a formal sale process, the prohibition on:
  - *inducement fees* (limited to *de minimis* fees of normally no more than 1% of the offer value), will not apply to an arrangement agreed with just one competing (white knight) offeror who announces a firm intention to make an offer after a hostile (and firm) offer for the target has been announced, and
  - *deal protection measures (more generally)*, will not apply to targets that are in financial distress where the Panel consents to this relaxation.

Public Identification of the Potential Offeror and 28-Day “Put Up or Shut Up”

In its October 2010 consultation paper, the Panel expressed its concern about the increasing trend for offerors to make a “virtual bid” whereby a potential offeror announces (or more often than not, becomes the subject of rumour after a leak to the press) that it is considering making an offer but without committing itself to do so.

The new rules proposed by the Panel will require, following an approach by a potential offeror to the board of a target company, that the potential offeror is named in any announcement that commences an offer period. This will be the case whether the target company is forced to issue the announcement because of an unusual movement in its share price or the potential offeror is forced by the Panel to make an announcement because of leaks. Thereafter, any publicly named potential offeror will be required, within a fixed period of 28 days from the date the potential offeror is publicly named, either to announce a firm intention to make an offer, to announce that it will not make an offer or to make an application jointly with the target for an extension of the deadline. The new rules will require that all potential offerors are named at the start of the offer period. Subsequent additional potential offerors will only need to be named where there is accurate rumour about the offeror or where, prior to an announcement by another offeror of a firm intention to make an offer, the target wishes to refer to a new potential offeror in any announcement.

The Panel says that it did consider allowing the target to decide whether potential offerors should (or should not) be named in announcements but has decided that the Code should require all potential offerors to be named (except as mentioned above).

In the Panel's view, these amendments will reduce the tactical advantage that hostile offerors have over target companies to the detriment of the target and its shareholders. This will come from shortening the time during which the target company is under "siege" prior to an offer being announced and by removing the potentially difficult decision from the target board as to whether or not to request a "put up or shut up" ruling by the Panel. In addition, potential offerors will be strongly incentivised to avoid a leak of their interest in the target because of the timing implications of a leak (which will require an announcement to be made).

Implications

These changes will generally put pressure on offerors to complete diligence and ensure that financing is in place before there is a leak or an announcement. Private equity offerors may be particularly affected given the difficulties in conducting due diligence and arranging appropriate "certain funds" financing in a four-week (only) period before a firm intention to make an offer must be announced (recognising that the Code generally does not permit offers to be made conditional on completion of due diligence or on financing). However, these changes could also conceivably work against a target that has been approached by an unwelcome suitor, if the target needs more time to find a white knight. More practically, for offers (and in particular exchange offers) that are also subject to the US tender offer and securities registration rules, which is increasingly common, the pressure on the timing of the process, given the need to prepare a US compliant offer document and registration statement and have these documents cleared by the SEC, will increase.

Prohibition of "offer-related arrangements" (including inducement fees)

The Panel's consultation paper issued in June 2010 raised the issue of, and its response issued in October 2010 stated the Panel's intention to prohibit, deal protection measures (referred to in the draft new rules as "offer-related arrangements") and inducement fees, and the draft rule changes reflect this prohibition.

The new rule will prohibit all deal protection measures, all inducement fees (subject to two exceptions described below), all implementation agreements of the kind now typically entered into between an offeror and a target in a friendly takeover, all exclusivity agreements and "work-fee" arrangements and any commitment given by a target to a potential offeror not to identify publicly the potential offeror in any announcement made by the target. Other types of agreements, such as an agreement to sell certain assets to an offeror, license agreements with an offeror or arrangements under which an offeror proposes to extend financing to a target, would also be prohibited.

The Panel's view is that without such a prohibition, such arrangements might deter competing offerors from making an offer, thereby denying target shareholders the possibility of deciding between competing offers on their merits and/or lead to competing offerors making an offer on less favourable terms than they might otherwise have done. Ordinary course commercial arrangements will not be prohibited, neither will confidentiality agreements (although confidentiality agreements will not be permitted to contain exclusivity provisions), nor will employee and customer non-solicitation commitments or agreements to provide information or assistance for the purpose of obtaining regulatory approvals. In addition, irrevocable undertakings to accept an offer given by directors in their personal capacity as shareholders or any agreement that imposes obligations only on the offeror (i.e. a "reverse break fee" or standstill agreement) will be permitted.

The "white knight" exception

The Panel considered that, when a firm but non-recommended offer has been announced, the target board's position might be strengthened if it is able to agree an inducement fee with a white knight. Therefore, the new rule changes will allow the target to agree an inducement fee with one competing offeror, of normally no more than 1% of the offer value. This could only become payable if an offer made by a party other than the white knight (including the original non-recommended offer) becomes wholly unconditional. The Panel will also be able to grant a dispensation from the general prohibition on break fees when a target company is in such serious financial distress that the board is actively seeking an offer to be made for the target company.

Implications

It is interesting to note that the majority of respondents to the Panel's initial consultation agreed with the Panel's current approach of permitting inducement fees. Such fees are, however, currently limited under the Code to *de minimis* amounts of normally no more than 1% of the aggregate offer price. Some would argue that such sweeping changes fail to acknowledge the commercial benefits of deal protection measures in encouraging offers that might otherwise not be made (or at least not be made at the initial price agreed). Conversely, however, the Panel stated in its consultation response paper that it believes that "standard packages" of deal protection measures, including inducement fees, might "deter competing offerors from making an offer, thereby denying offeree company shareholders the possibility of deciding on the merits of a competing offer". It said they may also "lead to competing offerors making an offer on less favorable terms than they would otherwise have done." The Panel also questioned whether deal protection measures actually secure offers or have instead come to be regarded as simply a standard feature of recommended takeover offers that target boards feel unable to resist.

On the other hand, some industry participants would argue that offerors, if denied inducement fees and other deal protection measures, take higher transactional risk. They may therefore initially bid less for the target to compensate for this (or indeed may not bid at all), as the expense and preparation of a failed bid may not be so trivial as to be ignored by all potential offerors. In the absence of deal protection, initial offerors may well make an initial bid below what they otherwise might have offered to avoid becoming a stalking horse for competing offerors (especially for a white knight that will be allowed an inducement fee), which may also result in reduced competing offers.

Other Proposed Rule Changes

The other rule changes proposed by the Panel broadly follow the proposals outlined in its October statement and are as follows:

- clarifying the existing position that target boards are not limited in the factors that they may take into account in giving their opinion on an offer;
- requiring the disclosure of offer-related fees and expenses (broken down by category of adviser);
- requiring the disclosure of the same financial information in relation to an offeror and the financing of an offer regardless of the nature of the offer (i.e. a securities exchange offer vs. a cash offer);
- improving the quality of disclosure by offerors and targets in relation to the offeror's intentions regarding the target company and its employees following the offer; and

- improving the ability of employee representatives to make their views on the offer known.

These other (and certain other more technical) rule changes proposed by the Panel have generated much less debate and most are aimed at enhancing disclosure generally.

A step forward or backward for UK takeover regulation?

Clearly, some would-be offerors will face additional challenges and restrictions when contemplating making offers for UK targets subject to the Code. These are likely to include private equity houses and certain other financial offerors, and indeed any offeror who has to arrange "committed" financing for its offer within the strict 28-day timetable following its identification as a potential offeror. They may also be concerned about the costs impact on their bids of the loss of any inducement fee cover for their pre-bid due diligence work, etc.

The rule changes may also place greater emphasis on the need to secure deal protection through alternative means, including through arrangements with larger target shareholders or through stake building (to the limited extent permitted under the Code) prior to announcement.

Nevertheless, although time alone will tell, it seems perhaps more likely that offerors will adjust to working to a potentially shortened timetable and come to accept the loss of the sorts of deal protection measures that are available in many other jurisdictions (some of which, in any event, have only relatively recently become common in UK offers). They may tend to view the rule changes as more unwelcome than "game-changing" in the area of UK public takeovers. Most target shareholders (and certainly target employees) will probably see these rule changes as a step forward, in the right direction.

A copy of the Panel's statement including the draft rule changes is available at:
http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/PCP201101.pdf

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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