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A legal update from Dechert's Corporate and Securities Group

Changes to the UK Takeover Code

A number of important changes have been made recently to the UK Takeover Code (the "Code") by The Panel on Takeovers and Mergers (the "Panel"). The changes follow a lengthy public consultation by the Panel in the wake of the Kraft-Cadbury takeover. The changes to the Code, which have been discussed in previous *DechertOnPoint* publications (see publications dated October 2010 and April 2011), took effect on 19 September 2011. 17 October 2011 was expected to be a watershed under the revised Code (for the reasons summarised below), with the stated intention of protecting target companies from a prolonged "bear-hug" by (possibly unwelcome) bidders. Whilst it is still early days, in this briefing we consider whether the changes—in practice—are closer to a sheep in wolf's clothing.

Protection for Targets against Protracted 'Virtual Bid' Periods

The most significant changes to the Code are those designed to increase the protection for a target company against a protracted 'virtual bid' (i.e., where a potential bidder announces that it is considering making an offer for the target, but without committing itself to doing so)—the so-called "bear-hug". There are two limbs to this protection: first, the announcement starting an offer period must identify the bidder by name; and, secondly, that announcement starts a mandatory 28-day "put up or shut up" period, in which the bidder must either announce a firm intention or withdraw.

1. An **announcement** made by the target, which starts an offer period, must identify that bidder and any other potential bidder with whom the target is in discussions or from whom it has received an approach (which the target has not unequivocally rejected) (*new Rules 2.4(a) and (b)*). This is an absolute requirement: the target has no discretion to withhold the identity of a potential bidder.

   Any subsequent announcements by the target which refer to a new potential bidder must now identify that bidder, except where (i) the target's announcement follows an announcement by a bidder of its firm intention to make an offer or (ii) following the grant of dispensation by the Panel in the event of a formal sale process (pursuant to *Note 2 on new Rule 2.6*).

   Additional identification requirements may also apply during an offer period. Where the target company is approached by an as-yet-unidentified potential bidder, the Code requires the target or the potential bidder to make an announcement of the approach and identify the bidder if there is rumour and speculation which correctly identifies that potential bidder (pursuant to *Note 3 to Rule 2.2*). Consequently, potential bidders will need to place greater emphasis on secrecy in the preparation of such bids in order to avoid earlier public identification than is desired.

2. The potential bidder must then, within **28 days** of the announcement identifying it, announce either a firm intention to make an offer (following which, that potential bidder is committed to making an offer) or that it has no intention to make an offer

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(the so-called ‘put up or shut up’) (*new Rule 2.6*). A potential bidder must therefore be ‘battle ready’ when approaching a target. The bidder could be identified and become subject to the 28-day ‘put up or shut up’ requirement immediately following such approach.

The Panel may, following an announcement by a target that it is seeking bidders by means of a formal sale process, grant dispensation from the requirement to comply with the identification requirements and the 28-day ‘put up or shut up’ requirement in respect of a potential bidder which participates in the formal sale process (*Note 2 on new Rule 2.6*).

The 28-day deadline may be extended by the Panel at the request of the board of the target. An extension is far more likely in a scenario involving a friendly potential bidder whose offer, if made, would be likely to be recommended by the target board. However, the Panel has been at pains to emphasise that an extension is only likely to be given shortly before the time at which the deadline is due to expire.

As expected, a flurry of extension announcements on 17 October (being 28 days after the changes became effective) gave the first indications as to how the Panel will implement Rule 2.6(c) and the basis on which extensions would be granted.

Of the various active offers and a strategic review announced on or around 19 September, extensions were announced on 17 October in relation to nine bids and the strategic review. One bidder, Saint Georges Participations SAS, announced that it would not be proceeding any further with its offer for DTZ Holdings plc. Discussions between Ladbrokes plc and Sportingbet plc in relation to the potential offer for Sportingbet, also announced on 19 September, ended on 10 October.

The extensions granted ranged from four days (in the case of one offer where the target board were not in a position to recommend the bid) to 32 days (in one case). Most of the extensions were however for 14 days (three cases) or 28 days (five cases, one of which was the strategic review).

There was no immediately discernable pattern as to the reasons applied by the Panel in granting the extensions and clearly the extensions granted were the result of discussions between the parties to the bid and the Panel. Reasons publicly stated included *“allowing [the independent directors] more time to seek clarification on certain aspects of the proposals, to further consider the merits of [the offer] and … to consult with minority shareholders”*; *“to allow [the finalisation] of terms that [the offeror] might be able to offer to [target shareholders]”*; and more general explanations relating to the time required to complete due diligence and/or final negotiations as to the terms of the offer. The four-day extension was granted to permit the offeror (in circumstances where the target board *“is not in a position to recommend the potential offer to shareholders”*) to enter into discussions with certain of the target’s major shareholders in order to obtain their views on the terms of the potential offer.

Commentary

Many commentators feared that these changes would be likely adversely to affect bid/deal activity—with expectations that many potential bidders would be dissuaded from approaching a target. In these times of reduced M&A activity generally, changes which seem likely to decrease those levels further have not been welcome. In particular, it was considered likely to deter potential private equity bidders, who often need additional time to arrange financing. According to a recent survey undertaken by the British Private Equity & Venture Capital Association, more than 90% thought that it would take at least six weeks for a potential bidder to organise a bid for a public target, and almost half of respondents said it would take longer than eight weeks to organise such a bid.

Of course, the counter-argument (not often heard above the vocal criticisms and concerns about the changes) has always been that the target board’s (and the Panel’s) obligations are to consider the best interests of shareholders. This frequently means (or should mean), at the very least, ensuring that a bona fide bidder has a fair opportunity (which requires sufficient time being granted) to put its best offer to the target board. That requires an element of balance between the competing interests of target and bidder—ensuring that target is not subjected to a bear-hug, whilst not stifling deal activity in the best interests of target shareholders.

It is not possible, based on the announcements on 17 October 2011 alone, to state any clear practice by the Panel, perhaps more telling will be the Panel’s approach in cases where targets approach the Panel to request a second extension. However, it would appear that the Panel has, initially at least, considered requests for extensions sensibly and pragmatically. As anticipated, where the bidder is not wholly unwelcome, the target board has been

willing to entertain further discussions, and the Panel has been willing to use its discretionary powers to extend the initial 28-day timeline, where the target board is unable, or unwilling, to recommend a bid, the early indications are that the Panel will be less accommodating—a victory for common sense perhaps?

Prohibition of Deal Protection Measures and Inducement Fees

Another significant change is the prohibition on a target, bidder and any person acting in concert with either of them from entering into an inducement fee or other offer related arrangement (*new Rule 21.2*). This prohibition applies during an offer period and when an offer is reasonably in contemplation. Such a prohibition is uncommon among jurisdictions with similarly developed financial markets. Therefore bidders for targets which are subject to the Code will not now be able to require target to give a break fee, "no-shop" covenant, right to match, implementation agreement (in the context of an bid by way of a scheme of arrangement) or similar.

One exception applies where a target is subject to an offer that is not recommended by its board. In that situation, the Panel will normally consent to a break fee in favour of a "white knight"—i.e., target entering into an inducement fee arrangement with a competing bidder at the time of the announcement of that competing bidder's firm intention to make a competing offer (*Note 1 on Rule 21.2*). This should be the case, provided that (i) the inducement fee (or fees, given that the target may agree an inducement fee with more than one white knight/competing bidder) which may be payable by the target is de minimis (no more than 1% of the value of the target, calculated with reference to the price of the competing offer), and (ii) the fee becomes payable only if a competing offer becomes or is declared wholly unconditional.

When calculating whether the fee which may be payable by the target is de minimis, the Panel will normally consider that (i) the 1% will be calculated on the basis of the fully diluted equity share capital of the target, but will take account only of those options and warrants which are 'in the money'; and (ii) any VAT payable as a result of payment of an inducement fee to a bidder (other than where the target can recover such VAT) will be included in the calculation.

The prohibition on inducement fees was introduced because it was considered that they had rapidly become automatic, standard provisions, with no room for negotiation on the part of target. The ability for target to solicit a bid from a white knight can be regarded as part of the exercise to support target and improve the target board's position in fending off unwelcome bidders.

The prohibition set out above does not include arrangements which (i) relate to confidentiality, non-solicitation of employees, customers or suppliers, or the provision of information or assistance in order to obtain official authorisations and/or regulatory clearance; (ii) contain irrevocable commitments or letters of intent; (iii) impose obligations only upon a bidder or those acting in concert with it; or (iv) relate to any existing employee incentive scheme (*Rule 21.2(b)*).

Target Company Boards Not Limited in the Factors that They May Take into Account in Giving Their Opinion on an Offer

The Code clarifies that it does not limit the factors which the board of the target company is able to take into account in giving its opinion on an offer. Further, the board is not required to consider the offer price as the determining factor (*Note 1 to Rule 25.2*).

Disclosure of Offer-related Fees and Other Financial Information

A bidder must disclose in its offer document details of the fees and expenses expected to be incurred by the bidder in relation to the offer, including separate estimates of the fees and expenses expected to be incurred by type of adviser (including financial and corporate brokerage, legal, accounting and PR) (*new Rule 24.16*). A bidder must set out in its offer document how the offer is to be financed and the source(s) of the financing (*new Rule 24.3(f)*). Targets are required to disclose in the target board circular details of the fees and expenses expected to be incurred by the target in relation to the offer (*new Rule 25.8*).

Disclosure by Bidders and Targets in Relation to the Bidder's Intentions Regarding the Target and Its Employees

The bidder must state its intentions regarding the future business of the target, in particular with regard to the continued employment of the

employees and management of the target and its subsidiaries (*Rule 24.2 (which was previously Rule 24.1)*). A bidder must make a negative statement if it has no intentions in relation to such matters.

A bidder which makes a statement of intention during an offer period must remain true to that statement for 12 months (or such other period set out in the statement) from the date on which the offer period ends (*Note 3 to Rule 19.1*). However, where there is a material change in circumstances, such a party would not be considered to be committed to such a course of action for such a period of time.

A number of respondents to the consultation suggested that those provisions relating to the employee representatives of the target should be extended to also apply to the trustees of the target's pension scheme. This was noted by the Panel, but no changes to the Code were made to effect this.

Employee Representatives

A number of changes are designed to improve communication between the target board and its employee representatives and employees. An opinion from the target's employee representatives on effects of the offer on employment must be appended to the target's circular, or (where the opinion is not received by the target in good time) the target must publish the employee representatives' opinion on its website and announce via an RIS that it has done so (*new Rule 25.9*). Additionally, the target is required to pay costs reasonably incurred by the employee representatives in obtaining advice required to verify information in the employee representatives' opinion.

There are concerns that the amendments to the Code will dissuade certain bidders from approaching a public target, let alone submitting a bid for a public target. The BVCA highlights that the changes to the Code provide protection for underperforming boards of directors, as there will be less 'market discipline' to regulate the boards' performance. The early signs, however, are helpful—if not overwhelmingly positive. There has clearly been a "re-balancing" exercise in favour of the target. However, it would appear that the Panel (if requested by the target board) is willing to apply the rules practically in all the circumstances, thereby giving bidders a fair opportunity to finalise its offer terms and/or complete its due diligence and structure an offer.

Given the significance of the changes, the Panel intends, subject to sufficient bid activity, to undertake a review of how the amended Code has operated in practice within 12 months of its implementation.

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