PCP 2009/2 – Miscellaneous Code amendments

Response of the Takeovers Joint Working Party of the City of London Law Society Company Law Sub-Committee and the Law Society of England and Wales' Standing Committee on Company Law

Below are the views of the Takeovers Joint Working Party of the City of London Law Society Company Law Sub-Committee and the Law Society of England and Wales' Standing Committee on Company Law (the "Working Party") on PCP 2009/2.

Q.1 Do you agree with the proposed amendments to Note 8 on Rule 9.1?

We wonder whether the description of the chain principle in the PCP has quite the right emphasis in relation to the philosophy behind the mandatory bid rule: it is common ground that a change of management should not lead to a mandatory bid, absent some change in shareholding ownership or structure. However some of the concerns identified in relation to a change of ultimate controller apply equally to a change of management (see for example paragraph 2.6). Further a change of the threshold for a mandatory bid may, in a small number of cases, have a very significant impact in requiring the Acquirer A (in the Panel's example) to offer an additional premium in circumstances where it is not appropriate: for example Company B may already have made a bid at a premium for Company C, which all shareholders had the opportunity to accept, with a minority electing to remain. The fact that there is a change of control at the level of Company B, it might be argued, should not give shareholders in Company C a right to an additional premium given that control has already passed. It would not be appropriate if the chain principle resulted in a change of indirect control effectively requiring a further premium to be paid, given that a shareholder which already has 50% of a Code-governed company can increase its holding above 50% without paying an additional premium.

We are not aware of problems having arisen in practice and it is not clear to us what the Panel wants to achieve in changing the Rule and why.

More specifically, we note the proposed deletion of the "main purposes" test and its replacement by a differently framed "significant purpose" test. We do not agree with the revised formulation for the test.

We believe the principal justification for the chain principle is that set out in paragraph 2.4(a) of the PCP and on that basis it should apply only if the acquisition of Company C is the main purpose (if it were not a main purpose, it is hard to see why a special premium would have been paid); the justification set out in paragraph 2.4(b) is a part of Rule 9 but is not the driving objective behind the scope of the chain principle. Put more bluntly, the chain principle is designed to avoid shareholders losing out because there is a bid for, or substantive change of shareholder ownership of, the parent company, Company B, which is really a disguised bid for the underlying Code-governed company, Company C.

The extension of the chain principle beyond situations where "one of the main purposes" is the acquisition of the Code-governed company, or the Code company represents 50% of the value, is a major and we think unhelpful change of philosophy. There is no logic to a 30% of value test or a "significant purpose" test save to provide a windfall benefit to shareholders who invested never expecting one (and an unexpected and potentially very significant cost to the ultimate shareholders of the parent Company B, who will now receive less value from a bidder than they are currently entitled to expect).

Once the chain principle test is changed from the concept of catching transactions which are backdoor bids for the Code company, there is no logical boundary. Why not require a bid where it is 1% of the value? This conceptual change intervenes too extensively in indirect ownership matters.

Shareholders in a controlled company accept, when they acquire their shares (or choose not to accept an offer), that they will have no influence over the identity of the board of the ultimate controller (Company B) or the strategy of that company. A change of the board of Company B resulting from a change of control of Company B is no different to a change of the board of Company B voted on by shareholders of Company B.

Overall, we do not think the case has been adequately made out for the threshold to be lowered. There is no need for there to be a parallel between this threshold and the 30% threshold in Rule 9. The two tests have no connection, as under the chain principle the percentage is to do with economic relevance, not control.

We suggest that the opportunity should be taken to clarify the position in relation to intra-group reorganisations. The Panel has consistently and helpfully taken the view that simple intra-group reorganisations above the level of Company B should not trigger chain principle bids. A lower threshold will bring this question into further scrutiny, i.e. as to what is an intra-group reorganisation and what is a substantive change of control. It seems to us that it would be helpful to include in a Note a comment to the effect that in normal circumstances intra-group reorganisations would not be caught. Another approach would be for the Code to make it clear that the Panel has discretion to grant a waiver.

Overall, given the complexity of the issues surrounding the impact of the chain principle and the different circumstances in which chain principle bids can arise for consideration, we question whether the proposed change achieves a sufficiently worthwhile policy objective.

Q.2 Do you agree with the proposed amendment to Note 2 on Rule 16, the proposed deletion of Note 4 on Rule 16, the proposed adoption of new Rule 16.2 and the Notes thereon, the amendment to paragraph 4 of Appendix 1 and the related amendments referred to above?

Rule 16 is about the equal treatment of shareholders and special deals with shareholders. The requirements should therefore, it seems to us, only apply to special deals where management have a shareholding in the target. The other matters that the consultation paper suggests need to be addressed are already governed by Code disclosure, the Companies Act and the Disclosure and Transparency Rules' disclosure requirements. To extend the scope of the Rule as suggested, in order to catch circumstances where management have no shareholding, would represent a significant change in policy. We believe this is the wrong approach and will confuse Rule 16 (significantly).

We think it is important to keep the Rule 16 concerns separate from consideration of the policy that should be applied generally to management incentivisation. This will be consistent with the Directive and ensures that the debate is appropriately focused. As implicitly acknowledged in the PCP, Note 4 on Rule 16 works well enough in dealing with equality of treatment concerns, although there is a case to be made that it would be helpful to set a *de minimis* level where management's shareholding is insignificant so that the Rules (except where management obtain an equity interest) would not apply. We do not accept that the second paragraph of Note 4 on Rule 16 has ever applied to incentivisation arrangements where management have no shareholding and if there is confusion on that, it would be helpful to make a clarifying amendment.

The real thrust of the Panel's proposal is that, for the first time, the Panel should regulate management incentive arrangements where equal treatment of shareholder concerns do not arise.

It is not a new point that for any company there is a balance between the relative value ascribed to management (or the workforce more generally) and that to shareholders. The public debate regarding remuneration is evidence of that. However, in the context of a takeover, these are issues that go to "financial or commercial advantages or disadvantages". They are therefore "matters for the company and its shareholders" and have not up to now been regarded as matters for the Code to regulate, other than as regards disclosure. The Code provides appropriate protection through the involvement of the directors (in particular, non-executive directors) in decisions on whether or not a transaction should be recommended and through the requirement for independent advice to be obtained. Further, where the shareholder response to the offer is not affected (where there are no "special deals" with shareholders) the free right of shareholders to respond to the offer has always been (and remains in our view) sufficient protection. We believe that this existing approach provides adequate and appropriate protection for shareholders. Disclosure is a separate question and we accept that there is a case for additional disclosure on incentivisation arrangements the offeror proposes for management (but see our comments below on the specific disclosure proposals in the PCP).

In addition to our objection as a matter of principle, we see little benefit in the main substantive proposal, that Panel consent or shareholder consent to the arrangements be obtained where there is no existing management shareholding involved. Requiring an independent shareholder vote in practice provides little further protection if voting down the resolution results in the loss of the offer. The PCP makes it clear that the offer and the incentivisation approval could be interconditional for a scheme. We assume that the Panel would therefore also agree that failure to obtain approval would allow an offeror to invoke a condition of an offer requiring that approval be obtained. If that is right (and if it is not, we believe the whole proposal would be totally unworkable), the shareholder in reality has one choice, namely whether or not to accept the offer, and the additional protection from the shareholder approval of the incentivisation arrangements is illusory.

In addition, extending the scope of the opinion required from the target's financial adviser to assessing the fairness of all incentivisation arrangements seems to us to risk going beyond the capabilities of financial advisers. Financial advisers are not experts in this area (i.e. senior executive compensation), which requires different expertise from the assessment of fair treatment in relation to shareholdings.

We suggest that disclosure requirements in relation to incentive arrangements should be dealt with under Rule 24 and Rule 25 (as this is a disclosure obligation and not a substantive requirement). We accept that disclosure should be required (a) if no arrangements are proposed, (b) if a specific proposal has been made and (c) of any agreement or understanding regarding such arrangements (this would already probably have to be disclosed under existing rules).

The proposed new Rule 16.2 (a) requires "full details" of discussions to be disclosed. "Full details" may suggest that it is necessary to include the level of disclosure that is required in the US. We strongly oppose such a sweeping disclosure requirement. We would suggest that the requirement should be to disclose "all relevant details of discussions" and the Panel should include guidance on what it would expect to see disclosed. We are also not clear how parties are expected to deal with the fact that discussions will continue after the document is sent out. Since by then the offer price and recommendations are clear, no update seems to us generally required, as the absence of "upfront" agreement on management incentives of itself supports the arms' length nature of subsequent discussions.

The proposed new Rule 16.2 (b) requires the Panel to be consulted where the value of any arrangements is significant and/or "the nature of the arrangements is unusual either in the context of the relevant industry or best practice". A number of members of the working party are concerned about the introduction of the concept of "best practice" into the Code. Our suggestion would be to require consultation where the value of the arrangements is significant and/or "the nature of the arrangements is unusual." It would also be helpful to have guidance on how to determine if an arrangement is "significant". We feel that the test should not be whether it is significant to the person being incentivised but whether it is significant in relation to the value of the offeree company. It would also be helpful to have examples of things that the Panel would treat as significant.

In our view it would be helpful for a note to make clear that ordinary course management incentivisation, such as share option schemes, falls outside the scope of the Rule.

We are strongly of the view that extending to non-shareholding management the financial adviser comfort/shareholder vote limbs applied now under Rule 16 is illogical and not a cost-proportionate approach. Many different value allocation decisions are made by boards (e.g. to joint venture partners, customers and suppliers as well as managers). As indicated above, shareholders do not need a vote on these as they have a free vote, through acceptance of the offer. Rule 16 is there to prevent that vote being "tainted". Where there are no management shareholdings, that risk cannot arise.

Q.3 Should the Code be amended to require display documents to be made available for inspection on a website in addition to hard copy form until the end of the offer (and any related competition reference period)? Do you have any comments on the proposed amendments to Rule 26 or the new Notes 2, 3, 4 and 5?

We support this amendment.

Q.4 Do you agree that the Code should be amended to delete Rule 26(c) as suggested above? Do you agree that Rules 26(d) and (f) should be amended as suggested above?

We welcome these proposed changes. In particular, the working party welcomes the deletion of the requirement to put on display material contracts which are not connected to the offer.

As an additional comment as regards documentation that should go on display, as has previously been raised with the Panel, some shareholders have raised concerns about Note 6 to Rule 24.2 which provides that disclosure regarding financing documentation is not required where the offer is solely in cash. Some shareholders (particularly institutions) are often interested in reviewing bid financing documents for a number of reasons, including when trying to understand the likelihood of a competing bid, ascertaining whether the offeror has the capability to lapse, close or even increase the bid and seeing the threshold below which the offeror needs its lender's consent to declare the offer unconditional as to acceptances (although they noted that some of these points should be disclosed elsewhere). In addition, target shareholders who are considering not accepting the offer and instead remaining as shareholders in the company may want to assess the financing arrangements to see what the offeror intends to do (or needs to do) as regards the target after the offer.

The working party therefore feels that financing documentation should be disclosed and put on display in all cases.

Q.5 Do you agree that the Note on Rule 2.7 should be amended to make clear that the ability of an offeror to choose not to proceed with an offer where a higher competing offer has been made should be subject to the consent of the Panel?

We agree with this amendment. It would be helpful if the Takeover Code included a note referring to the factors that the Panel will take into account, as set out in paragraph 5.7 of the PCP. These are too significant to be left in a PCP/RS.

Q.6 Do you agree that Note 5 on Rule 21.1 should be deleted?

We feel it would be dangerous to dispense with the note and that the note should be retained in Rule 21 so that the consequences of taking frustrating action are clear. Furthermore there is no suggestion currently in the note that the Panel applies the same threshold in determining whether an offeror can lapse its offer as that contained in Rule 13.4. Does the proposed deletion of the note signify a change in the approach of the Panel when exercising its discretion under Rule 21? If so, this ought to be made clear by stating in Note 5 that the Panel will have regard to Rule 13.4. We suggest that this is a preferable approach and confusion may arise if the proposed approach (to the same end) is implemented.

Q.7 Do you agree with the proposed amendment to the Note on Rule 2.7 as set out above and to the proposed consequential amendments?

See comments in response to Q.6 above.

Q.8 Do you agree that Rule 12.2 should be amended as proposed?

We agree that it is helpful to clarify the restrictions that apply to an offeror which decides that it does not wish to continue to seek competition clearance or which is not allowed to proceed and that six months is the appropriate limit

Q.9 Do you agree with the proposed amendment to Rule 31.3?

The working party agrees with this amendment.

Q.10 Do you agree that Rule 25.3(a)(v) should be amended as proposed?

The working party agrees that if directors have decided which offer they will accept at the time the offer document is published then that information should be included. However, in some circumstances a director may not have made a determination by that stage. For example a director's decision is, at least in part, likely to be influenced by the tax treatment which may vary according to the timing of the offer going unconditional, which may of itself be uncertain at launch. We are clear that a director should not be forced into making an early election. We would suggest that the rule requires disclosure in the offer document where the decision has already been made. Where the directors have not yet made the decision, disclosure could be required as and when that decision is made.

Q.11 Do you agree that Rule 27.1 should be amended as proposed?

The working party agrees with this amendment.

Q.12 Do you agree that Note 6 on Rule 9.1 should be amended as proposed?

The working party agrees with this amendment.

Q.13 Do you agree that Rule 36 should be amended as proposed?

The working party agrees with this amendment.