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Our ref

Your ref

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Dear Robert

I am writing on behalf of the Takeovers Joint Working Party of the City of London Law Society's Company Law Sub-Committee and the Law Society of England and Wales' Standing Committee on Company Law to set out our response to PCP 2011/1.

We support the approach taken in many of the clarifications provided in the PCP and the detailed draft Rules: a number of these will facilitate more effective implementation of the proposed changes. However, we have significant concerns which we wish to raise on two proposed changes in particular and this response focuses exclusively on these. We have also attached a note of additional points for consideration by you and your colleagues. If it would be helpful, we would be pleased to discuss further or clarify any of the points raised in this response or that additional note.

A. Context

We welcome a significant number of the clarifications which the PCP provides, in particular as regards:

(a) the position on extensions of time for bidders subject to the new PUSU timetable where the target supports the extension; and
(b) the position on break fees for "white knights".

Both of these support the Panel's objective of strengthening the position of offeree boards; we consider that the proposed clarifications which the Panel has put forward to its earlier proposals in these respects will be useful in practice in ensuring the interests of offeree shareholders are better protected and value opportunities for them are not inappropriately lost.

We also welcome the clarification of how scheme of arrangement timetables will be set and work and, subject to our points of detail on this, again we see this as consistent with the principle of enhancing target board control, whilst ensuring that a structured timetable will generally be pursued by targets.

Our two significant concerns relate to:

- the requirement for all potential offerors to be named at the time of any Rule 2.4 announcement (or, as an alternative for any potential offeror wishing to avoid being named, for it to withdraw, assuming no naming is then required for market disclosure purposes); and

- the imposition of a formalised private lock-out of potential offerors which have withdrawn, rather than be the subject of identification in a possible offer announcement.

We are concerned that in seeking to protect offeree companies from unsolicited " virtual bidders" these proposed changes present material impediments to the ability of offeree companies to negotiate recommended transactions with offerors who are welcome and provide an outcome for shareholders that the offeree board believes is the best available. Our proposed solution is in each case to restore the role of the offeree board in making determinations of whether the requirements should be imposed. We recognise that this may in some cases require the offeree board to make "a potentially difficult and contentious decision" but:

(a) those few cases should be balanced against the (we think very many more) cases where an offeree board wishes to manage an orderly process;

(b) offeree boards should not feel unduly vulnerable to pressure in making this determination; if, as we suggest, the rule is set up so that the default option is to require disclosure or impose the lock-out, the offeree board will be able more easily to defend a decision not to request confidentiality.

Our comments below include references to illustrations of situations which we foresee arising if no change is made to the proposals. These are appended as examples.

B. <u>Key Issues</u>

1. <u>Proposed requirement to name all potential offerors</u>

Proposed new Rule 2.4(a) provides for the naming of "any potential offeror with whom the offeree company is in talks or from whom an approach has been received (and not unequivocally rejected)". This requirement to name potential offerors is new.

We see a number of objections to this requirement as proposed:

- it will be open to abuse by offerors;

- it is inconsistent with the approach elsewhere

- it introduces new and unhelpful complexity.

The PCP considers the implications of this proposal both where there is only one potential offeror and where there are multiple offerors.

These objections to the proposal would be overcome if the rule was subject to a general carve-out where the offeree does not wish the potential offeror to be named and disclosure is not otherwise

required. Accordingly, we believe that the "alternative approach" set out at paragraph 2.22 of the PCP should be adopted. The advantage of this approach is that it allows the board of the offeree to ensure that a potential offeror (or offerors) with which it is in friendly talks is (are) not forced to walk away to avoid disclosure of their identity, thereby diminishing the options available to the offeree board and its ability to achieve the best deal for its shareholders. Adopting the "alternative approach" in this way would be a major contribution to the "offeree board empowerment" objective. See, by way of illustration, Examples 1 and 2 attached.

The objections made to the "alternative approach" in the PCP are unconvincing:

(i) application of PUSU: the discussion in paragraph 2.23 proceeds on the basis that the 28 day deadline will be enforced in respect of a potential offeror whose identity is not disclosed *at the request of the offeree*. We think this unlikely. If the offeree is sufficiently enthusiastic for the talks to continue without disclosure, it seems most likely that the conditions for an extension will have been met. In the more limited number of cases where there is no extension, the solution proposed in paragraph 2.23 seems reasonable;

(ii) in relation to the points made in paragraph 2.24, we disagree with the proposition that "the chances of an offeror not being publicly identified would only be marginally less under the alternative approach". There are many examples that under the current regime of friendly talks that continue after a 2.4 announcement that does not disclose the potential offeror's identity (and which have often led to a recommended offer).

The further objections we have heard expressed to the alternative approach are equally unconvincing:

(iii) "it lacks transparency and the market needs to know the identity of the potential offeror to evaluate the prospects of an offer being made": as set out at section (d) below, the Code will continue to allow potential offerors to remain unidentified and shares to trade without knowledge of a possible bid, (1) where there has been no leak and (2) after an offer period has commenced: it is clear therefore (rightly) that the regime does not demand disclosure of all potential offerors at all times and the policy justification for avoiding disclosure at those stages (deterrence effect on welcomed transactions, if identity disclosure was required early) applies equally to avoiding naming at the start of the offer period, where the target wishes to avoid naming of the offeror; if, in a particular case there are special reasons requiring disclosure (e.g. speculation regarding the identity of the potential offeror), the Panel could insist on it;

(iv) "it will lead to exploding offers," ie offers which will be deemed withdrawn either on a particular date, or on a leak or rumour appearing in the market that would or might require announcement: we consider that the new disclosure obligation will in any event lead to such an approach, but that the need for it will be moderated if targets can choose to allow offerors not to be named. We do not see any disadvantage, in any event, in practice moving to a clearer status as to whether an offeror is still pursuing an approach or not;

(v) "it is unfair on the target", which is in the public focus when the offeror may not be: an offeree consent regime would permit non-identification of potential offerors (with presumption of disclosure) would allow offerees to decide whether non-disclosure was

unfair or in their interests, rather than face the the unfairness of being deprived of an opportunity which the offeree wants to pursue.

Set against the advantage of allowing the offeree to manage the process to encourage potential offerors to remain interested are the claimed advantages of the proposed approach set out in (a) to (d) of paragraph 2.24. Of these, we do not see how offerors have a tactical advantage if the offeree controls the question of disclosure (on the contrary, we see tactical advantages for some offerors if the offeree does not (see further below)); for the reasons explained above, we think the PUSU regime will operate satisfactorily under the "alternative approach"; and we do not think the offeree board has a difficult decision. In this context we suggest that the "alternative approach" be implemented in a way that makes disclosure the default position, with anonymity maintained only if requested by the offeree. Although we recognise that shareholders and the market would like to know the identity of potential offerors, if the consequence of the rule is that offerors are driven to withdraw, are shareholders' interests best served? We think not.

(a) Scope for abuse by offerors

We believe that the proposed requirement for all offerors to be named when an announcement of a possible offer is made will be open to abuse, by some potential offerors (in particular some of those "virtual offerors" which the changes are intended to restrict) to the disadvantage of offeree boards and shareholders.

A possible offeror that has made an approach could by a leak trigger an announcement by the offeree in order to force the other potential offerors to accept public disclosure of their interest, or to withdraw and be precluded from continuing to work on developing an offer, as set out at paragraphs 2.56 to 2.58 of the PCP.

Furthermore, it is clearly the case, based on our experience, that a substantial proportion of possible offerors, in particular those offerors which are undecided about whether or not to proceed, or reluctant to be seen to be interested in an offer but then to "fail", or reluctant to have to explain to their own shareholders their interest before transaction terms are agreed, are not willing to be named as possible offerors and will break off talks/their plans, if to continue would require them to be named. They would not be allowed under the proposed new regime to re-engage within three to six months, unless a formal offer is launched by a third party (or one of the equivalent exemptions is triggered).

Accordingly, any possible offeror, in particular an unsolicited one seeking to put the offeree "in play" and to maximise its own advantage, will under the proposed new Rule have a direct incentive once it is confident that it will be in a position to launch a bid within four weeks, to approach the offeree and then leak its interest. See Example 3 attached, by way of illustration.

We acknowledge that any other potential offeror that might compete with the named first potential offeror but which withdraws without being named can then re-commence its interest if the first potential offeror launches an offer. But by then it may be too late: the first offeror could for example have obtained irrevocable undertakings to accept its offer from shareholders, which effectively preclude any new competing offer, or diligence or regulatory timetables may leave the competing potential offeror too far behind to be able to compete.

(b) Inconsistency of approach

(i) Parallel with offeree support for PUSU extensions

The proposed approach to extensions of time under the new PUSU regime reflects the broader principle and objective of enhancing offeree board control in takeovers through the acknowledgement that the offeree's view is in general to be determinative of the position, subject to the Panel's own ability to check abuse and intervene where it believes appropriate. We see no difference in principle between the offeree board's decision on extension and the offeree board's view on naming a potential offeror: each is a decision that may deprive shareholders of the opportunity for a particular potential offeror to develop into a formal offer: we do not see a difference in the degree of difficulty in the offeree board's decision.

(ii) Post offer disclosed but unidentified potential offerors

Under the proposed new regime, it would be accepted that a potential offeror would not necessarily be required to be named (or, as an alternative, to agree to withdraw and be locked out for three to six months) after the announcement of a firm intention to make an offer by a third party – this demonstrates that the regime continues to accept (rightly, we believe) that the existence of potential offerors may be publicly known during an offer period, without requiring identification of such potential offerors.

This leads to inconsistency and arbitrariness which is easily demonstrated by an illustration: see Example 4 attached.

The inconsistency on the alternate facts of the example seems to us to speak for itself as giving rise to arbitrary and unsatisfactory outcomes. This would not arise if the offeree has the power to determine whether the obligation to name each potential offeror can be relaxed.

(c) Complexity

The proposed new approach to identifying potential offerors is too complicated and will result in market confusion:

- additional potential offerors do not need to be named where a possible offer announcement is made by a first potential offeror, but do where the announcement is made by the offeree: the circumstances behind the regime as to which party has a duty to announce are already complicated and not universally understood by investors;

- a potential offeror does not need to be identified in a formal sale process situation, notwithstanding the announcement by the target of that situation;

- a potential offeror does not need to be named, even where its (unidentified) existence is in the public domain, once a formal offer announcement has been made, but would do prior to such period.

Whilst of course a rationale for each of these distinctions can be articulated, in practice it would be far simpler to provide that potential offerors should be publicly identified save with offeree consent or, if necessary, with offeree consent and subject to Panel approval, as per extensions to the

PUSU deadline. The inconsistency of approach proposed demonstrates the flaw in the argument that disclosure of offeror identity is required for transparency (ie, it is just required some of the time and it will be hard to follow when it is and is not so required).

(d) What constitutes a "potential offeror"?

The proposed approach to identification will result in even greater focus on what constitutes a potential offeror. We assume that the Panel intends that a party ceases to be a potential offeror not only on "unequivocal rejection" by the offeree but also upon "withdrawal" or "unequivocal withdrawal" by the potential offeror. The disclosure obligation on its face only applies to a "potential offer or: ie "offeror" a person who has made an approach but genuinely withdrawn, does not seem to us to be capable of being said to be still a "potential offeror", otherwise it would seem unworkable. Increasing focus on such a distinction, as opposed to on the offeree's wishes, will simply lead to potential offerors after each step of engagement introducing withdrawal notices, or requiring rejection notices pending the next contact. Again the "alternative approach" substantially avoids such issues.

(e) Conclusion

The above issues, we strongly believe, demonstrate that any perceived advantages in flushing out publicly all potential offerors (for example where there has been a leak by a potential offeror, but it is unclear by which one), are more than outweighed by the disadvantages if no flexibility is introduced. In particular, we anticipate that this new approach to identification will impede credible "real" value accretive offers, welcomed or solicited by offeree boards more than it will affect hostile "virtual bids" or similar proposal.

There is no doubt in our experience that hostile virtual bidders are typically more likely to be happy to be identified publicly than credible bidders, which are often more likely to be deterred and to withdraw (and then be locked out for three to six months, often following a leak in which they had no part), directly contrary to the clear wishes and interests of the offeree and its shareholders. Again, these problems can all be successfully and substantially mitigated, consistent with the overall approach of enhancing offeree board influence, by adopting an approach along the lines of the alternative approach canvassed in the PCP. Indeed such a provision would self evidently support offeree board empowerment.

2. Proposed lock-out of potential offerors withdrawing to avoid being named

The PCP sets out a description both of the Panel's view of the current position where a "dispensation" is granted from the requirement for an announcement under Rule 2.2(c) or 2.2(d): i.e. where, at the time of the relevant share price movement or rumour and speculation occurs, the relevant potential offeror has ceased actively to consider an offer.

We do not entirely agree with the description of its current application of the regime described in paragraph 2.62 to 2.64: we suspect this arises from focus by the Panel on situations where an obligation to announce under Rule 2.2(c) or (d) is clearly triggered and the decision not to require an announcement is clearly a dispensation by the Panel (when terms can legitimately be imposed by agreement on the relevant potential offeror): the Code currently contains no power for the Panel to impose a shut-out of a potential offeror from making an offer otherwise than where it has unsuccessfully made an offer or where it has been named as a potential offeror.

We have two principal concerns with this proposal:

(a) The risk of being forced into a withdrawal and a lock out, in order to avoid premature public disclosure, will be a material impediment to significant numbers of bona fide offers, welcomed by targets; the problem will be particularly severe for a potential offeror that is consistently the subject of speculation on a transaction (for example, by virtue of reasons of self evident commercial rationale), which will be discouraged from making an approach even where the approach would be welcomed by the offeree, increasing the number of potential offerors which have to withdraw in order to avoid being named; and

(b) the six months lock-out (or three months with offeree support) seems wholly disproportionate to an entity which ceased to be a potential offeror before any rumour or speculation occurred, or for example in a situation where the relevant rumour or speculation did not trigger any material share price movement, or there was a subsequent share price movement without rumour or speculation. It also runs counter to the offeree board empowerment principle, that a minimum three month period to re-engage be imposed.

Yours sincerely

James Palmer
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Example 1

Day 1: Company A approaches Target X about a possible offer. Talks commence but it is unclear whether A can offer a sufficient price.

Day 15: Target X decides to approach Company B in case Company A's offer falls below a level sufficient for a recommendation, as a possible white knight. Company B is listed and sensitive to publicity regarding its interest in Target X before it can explain detailed rationale and impact to its own shareholders.

Day 20: Company A's approach is leaked. A rule 2.4 announcement is made. Company B withdraws, contrary to Target X's strong wishes.

Day 48: Company A launches a hostile bid. The market is not aware of any possible counter bid. Company A buys a 20 per cent block of shares on the market. Company B decides to remain withdrawn, either given the stake now held by company A, or on the basis that Company A has too much momentum and Company B does not wish to enter a prolonged contested bid, with risk of losing, as distinct from its preferred outcome of being the first and recommended bidder.

Company B would have paid more than Company A.

Example 2

Day 1: Target X and Company B enter into agreed merger discussions, under which Company B would be offeror. Target X has a strategic choice: combine with Company B, or sell its business which fits with Company B's to a third party within two months, Third Party D.

Company B is listed and sensitive to publicity regarding its interest in Target X before it can explain detailed rationale and impact to its own shareholders.

Day 7: Company A, which has no financing available and is one-third of the size of Target X, approaches Company A. The approach is immediately leaked.

Company B withdraws and is precluded from bidding for 6 months, or at least 3 months with Target X's consent.

Day 35: Company A has been unable to announce a firm intention to make an offer and announces its withdrawal.

Target X is unable to engage with Company B, so has to pursue the disposal of assets to Third Party D.

The transaction with Third Party D provides lesser value to Target X than a merger with Company B would have done, in the view of the board of Target X, but is under the circumstances the more certain choice.

Example 3

Day 1: Target X's board decides to explore value options. Acknowledgement of need to sell Target X would undermine confidence in its business, so no public auction is launched. However X instructs its financial advisers to sound out interest from a small number of possible acquirors of Target X.

Day 7: Company A and Private Equity Firm B are approached. Company A is a strategic bidder with cash resources. A and B are each told a handful of possible acquirors have been approached, with a view to moving within two weeks proceeding with a preferred offeror, or terminating discussions.

Day 14: Company A's identity as leaked to a potential offeror for Target X. Private Equity firm B withdraws rather than be named. Discussions between Target X and Company A continue as does Company A's due diligence.

Day 42: Target X supports an extension of 2 weeks to Company A's timetable.

Day 56: Company A makes a recommended offer for Target X. The Board of Target X believes that Private Equity Firm B would have been the preferred fit, but could not clarify if it would bid or raise the financing required.

Private Equity Firm B will not re-enter by launching a contested bid. It could have financed a higher bid with 4 to 6 weeks of due diligence.

It is suspected by all that Company A leaked its interest to see if that deterred other more publicity-shy potential offerors.

Example 4

Day 1: Consortium B approaches Company A with a takeover proposal.

Day 16: After ostensibly informed rumours of Consortium B's interest in Company A are reported in the press, a possible offer announcement is made identifying Consortium B. Consortium B is well progressed in its approach and keen to be able to engage shareholders, so they in turn may apply pressure to the board of Company A to allow an offer to proceed on a recommended basis.

Alternative (1)

Company A's chairman and the chairman of Company C "on the golf course", on day 15 (i.e. the day before public disclosure of B's interest) have a discussion, initiated by the chairman of Company A (the offeree) about C's interest in combining with A. The chairman of Company C confirms that his company has always been interested in acquiring/merging with A and suggests meetings in three or four weeks time to progress matters.

The leak of Consortium B's interest would require Company C either to be named as a potential offeror, or to withdraw and be precluded from bidding for three to six months or until an earlier formal offer announcement by Consortium B.

Alternative (2)

As per (1), but the "golf course" discussion occurs on day 17, i.e. the day following the possible offer announcement triggered by rumours of Consortium B's interest.

In that situation Company C is not required to be identified publicly and its existence as a potential offeror need not be publicly disclosed on a named or unidentified basis.