

# WEB CHAPTER A: THE MARKET FOR CORPORATE CONTROL\*

## A: INTRODUCTION TO THE MARKET FOR CORPORATE CONTROL

### I Markets and managerial agency costs

#### 1 *Product, managerial labour and capital markets*

In Chapters 6–15 of this book we have looked at how different corporate legal strategies function to ensure that corporate power is exercised by the board and by management in the company's interests and not in the directors' or managers' own interests. Each of these legal strategies focuses on how law organizes and regulates the internal structures and operations of the company to achieve these goals. However, the ways in which boards and managers exercise power and authority is not merely a function of the internal structure and regulation of the company but also a function of how the company, its board and its management interact in external markets. These external markets have the potential to perform a regulatory function similar to internal corporate legal and governance mechanisms: they may operate to ensure that corporate power is not used by the board and by management for their own benefit. There are several market places within which the company, the board and its management interacts; each of which may perform this regulatory function to different degrees, depending on the nature and operation of the market. There are four such market places which concern us here: the product market; the market for managerial services; the equity capital markets; and the market for corporate control.

#### 1.1 Product markets

The most important of the company's markets is, of course, the market place where the company sells its products, where, for example, Bob's Electronics Plc sells its build-to-order computers. In a highly competitive product market only those companies which impose tight control over all aspects of their costs will make a profit and survive. In such a competitive market place management will have very little room to incur managerial agency costs because if such agency costs, such as excessive perquisites or over-priced supplies provided by a self-dealing director, are incurred it may mean that the company's products cannot be priced competitively and at the same time generate income in excess of expenditure. A rational manager would not, therefore, incur those costs if by so doing the likelihood of the company failing and her losing her job would increase significantly. If competitive markets for products effectively constrained managerial agency costs, the legal strategies that have occupied so much of our time in Part II of this book would be of far less importance than we have attributed to them, as managers would have limited scope in practice to misbehave.

In the real world, markets have become increasingly competitive in recent years as a result of a range of factors that are often placed under the umbrella term 'globalization'. These factors

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include: the reduction in nation state trade barriers; reduced costs of international transportation; and the increasing ease of cross-border communication. It is correct to say, therefore, that product markets place some constraint on managerial agency costs, although this will vary considerably between different product markets. Nevertheless, although markets may have become increasingly competitive, the imperfect competition<sup>1</sup> found in many product markets may leave considerable scope for managers to incur significant agency costs and to continue to price the product so that it sells successfully.<sup>2</sup>

## 1.2 The market for managerial and director services

The market for managerial and director services is the employment market place for managers and directors. If this market place is informed about the self-serving or incompetent behaviour of a manager his reputation as a manager will be damaged and it will be difficult for him to find as prestigious and as well paid a job as the senior manager of a similarly situated company should he be removed from his current managerial post.

In theory the market for managerial services could operate as a significant disincentive to disloyalty or incompetence. However, in relation to disloyalty in particular several factors undermine its effectiveness in practice. In the absence of successful legal process there may be no reliable signal to the market place that any such costs have been incurred by management: pay may be excessive but justifiable by comparison with other companies; the market may never find out about the corporate opportunity indirectly but personally exploited by the manager; the market place will be poorly placed to determine whether a self-dealing transaction was on fair market terms; and the market has great difficulty in seeing at all the perquisites of power that a manager may award himself. Even where a manager loses his job as a result of such behaviour, the board may not, in the absence of legal process, disclose such information about the incurred agency costs for fear of sullyng their own or the company's reputation, or out of concern to show due regard to collegial 'good form'. Furthermore, for those directors who are at the end of their careers, or have sufficient personal wealth or a large enough pension to retire early, the market for managerial services operates as no constraint at all.

Although there are practical limits on the disciplinary effect of the market for managerial services, as we discussed in Chapter 13 the market for non-executive director talent may operate to impose some constraints on the incurrence of agency costs through self-dealing transactions. For listed UK companies the UKLA's Listing Rules require ex ante disclosure and disinterested shareholder approval of any non *de minimis* self-dealing transactions.<sup>3</sup> As any material self-dealing transaction may readily be viewed – whether rightly or wrong – by the financial media and the market place as suspicious, this disclosure and approval requirement may discourage non-executive directors from agreeing to enter into any such transaction for fear that even requesting approval for such transactions may be interpreted by the market place as a failure by the non-executives to perform their monitoring function. Such reputational 'market value' effects are also likely to operate to control the approval given by

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<sup>1</sup> Begg, Fischer and Dornbusch's economics textbook define perfect competition as follows: 'firms in a perfectly competitive industry face a flat or horizontal demand curve... No matter how much the firm sells it gets exactly the market price. If it tries to charge a price in excess of [that market price] it will not sell any output' (D. Begg, S. Fischer and R. Dornbusch, *Economics* (3rd edn, McGraw-Hill, 1991), 133.

<sup>2</sup> On the survival of non-profit maximizers see S.G. Winter, 'Economic "Natural Selection" and the Theory of the Firm' (1964) 4 *Yale Economic Essays* 225.

<sup>3</sup> Listing Rule 11.

listed company boards (to the extent that the articles provide that is possible)<sup>4</sup> for all but the most unrelated business opportunities. Accordingly, reputational capital in the market for non-executive directors may have important regulatory effects when they interact with existing legal rules.<sup>5</sup> Of course the resulting restrictive approval regimes may drive 'bad managers' to conceal the self-dealing or quietly exploit the corporate opportunity.

### 1.3 Capital market discipline

In several instances in this book we have made reference to the idea that capital markets are efficient.<sup>6</sup> This idea is that capital markets incorporate the information that is made available to them into the price of a company's shares. Proponents of this idea argue that the markets are 'semi-strong' efficient;<sup>7</sup> that is, they incorporate into the price of shares all publicly available information, but not privately-held information, about the company.<sup>8</sup> This efficiency idea is known as the 'efficient capital markets hypothesis'. The hypothesis does not assume that everyone buying and selling shares is aware of the available public information and that they assess the relevance of the information for the price of the shares, rather it assumes that there are enough market participants who are 'smart enough' and in control of sufficient wealth<sup>9</sup> to move the shares in the right direction if uninformed traders move the share price in the wrong direction. If the price of the share is too high (according to an informed assessment of the publicly available information) then these smart participants will sell those shares or sell those shares 'short', which effectively involves selling a share you do not own in anticipation that its value will drop. If the price of the share is too low in light of the available information the smart investors will buy the shares, which in their view are trading cheaply. This selling and buying activity will, over time, move the share price towards a price which incorporates the publicly available information. Importantly, one might ask: who are these smart participants? There are several possibilities in this regard: highly informed and skilled investors investing their own money; highly informed and skilled investors investing other people's money, for example hedge funds; or investors who themselves are not very informed but rely on the analysis and reports produced by

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<sup>4</sup> Section 175(5) CA providing that public companies can elect in their articles for disinterested director approval for the taking of corporate opportunities. See further Chapter 14.

<sup>5</sup> See J. Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment' (April 2008). ECGI – Law Working Paper No. 106/2008. Available at SSRN: <http://ssrn.com/abstract=1133542>.

<sup>6</sup> See, for example, Chapter 3 pp 85–7.

<sup>7</sup> See E. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work (1970) 25 *Journal of Finance* 383. E. Fama, 'Efficient Capital Markets II' (1991) 46 *Journal of Finance* 1575.

<sup>8</sup> Of course some of this privately-held information may seep into the share price as a result of illegal trading on that information by insiders (insider trading).

<sup>9</sup> Or access to borrowed funds – leverage.

market professionals known as securities or research analysts.<sup>10</sup> In this regard consider the following account of the mechanisms that renders share price informationally efficient.

**R. Gilson and R. Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 *Virginia Law Review* 549**

Much so-called 'public' information is not universally disseminated among traders. Many traders are too unsophisticated to make full use of the technical accounting information contained in mandated disclosure reports;<sup>11</sup> much disclosure data is accessible in the first instance only through documents on file with government agencies;<sup>12</sup> and much information about a firm's prospects may be announced initially only to small groups of securities analysts and other market professionals. How, then, do prices come to reflect this semi-public information? The answer, as identified in general terms by Fama<sup>13</sup> and many others, is that rapid price equilibration does not require widespread dissemination of information, but only a minority of knowledgeable traders who control a critical volume of trading activity. From this perspective, the universally informed trading mechanism is actually only a special case of price formation through the activity of traders who are direct recipients of information. Subgroups of informed traders, or even a single knowledgeable trader with sufficient resources, can also cause prices to reflect information by persistent trading at a premium over 'uninformed' price levels. The rapidity of such price adjustments depends on the volume of informed trading. And although a precise account of that process has yet to be offered, it seems plausible that the relative efficiency of price adjustment to new information that proceeds through professionally informed trading declines only gradually as initial access to the information narrows to a threshold minority of traders, after which it declines rapidly.

In today's securities markets, the dominant minority of informed traders is the community of market professionals, such as arbitrageurs, researchers, brokers and portfolio managers, who devote their careers to acquiring information and honing evaluative skills. The trading volume in most securities that these professionals control,

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<sup>10</sup> Securities or research analysts are individuals, trained in the art of financial and business analysis, who write reports on companies and make recommendations to investors about whether to buy or sell shares in those companies. There are two primary types of analysts: sell-side analysts and buy-side analysts. Sell-side analysts are typically employed by a broker – a person who executes trades in shares – investment banks often provide brokerage services. The brokers provide the research reports to their clients who may then buy the shares. Buy-side analysts are employed by fund managers, who manage the institutional investor funds, and they make recommendations to managers about which shares to buy. Analysis is expensive and analysts only cover a limited number of companies. This means not every listed company is subject to coverage by a research analyst. To the extent the efficient capital market hypothesis relies on analysts providing the necessary information to investors, it is inapplicable to companies not covered by securities analysts.

<sup>11</sup> On the disclosure of accounting information see Web Chapter B, Part B.

<sup>12</sup> See Web Chapter B, Part A on disclosure and the mechanisms of disclosure in the UK.

<sup>13</sup> E. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383.

directly or indirectly, seems sufficient to assure the market's rapid assimilation into price of most routine information...

In sum, the professionally informed trading mechanism explains why any information that is accessible to significant portions of the analyst community is properly called 'public,' even though it manifestly is not. Such information is rapidly assimilated into price... And it is these characteristics, we submit, that largely convey the meaning of a 'semi-strong form' market response.

There are several types of 'public' information which, according to the efficient capital markets hypothesis, is incorporated into the share price. Such information would include the following information types:

- Information about the company's financial position (its financial statements).
- As we saw in the extract set forth in Chapter 3,<sup>14</sup> Easterbrook and Fischel argue that information about the legal rules that govern the company are incorporated into the price of a share. This would include those rules set out in the corporate statute, the corporate constitution and also those rules set out in case law. If a set of rules (Rule Set A) would allow managers of a company more scope to act in their own interests than a different set of rules (Rule Set B), then two identical companies with identical predicted future cashflows from the sale of their products would be valued differently if they were governed by Rule Sets A and B, respectively. The company with Rule Set A would have a lower valuation to take account of the fact that more managerial agency costs could be incurred.
- Public information about a company would also include any information about managerial misbehaviour or incompetence. If, for example, capital market participants are made aware of self-dealing transactions and the market views the terms of those transactions as unfavourable to the company then the market will incorporate into the share price the likelihood of future misbehaviour. Markets acting efficiently will respond similarly to their assessment of managerial competence or incompetence. Of course much of the information about agency costs is private and is not available to the market. There may, for example, be stories that circulate in the market place about managerial extravagance and perquisites but the market will not be aware whether such extravagance is funded out of the manager's or the company's purse.

Accordingly, *if* the efficient capital markets hypothesis is correct, then the price of a company's shares will incorporate both a discount to take account of the potential for incurring agency costs *allowed* by the governance rules applicable to the company, but also any information made available to the market about actual managerial abuse or incompetence. The incorporation of this information into the share price facilitates the operation of several mechanisms for dampening management's incentives to misbehave. The market for corporate control, considered in the next section, is one of those mechanisms. Other important mechanisms would include managerial remuneration that is linked to the company's share price and the disciplinary effects of a company's cost of capital. Where remuneration is linked to the share price, misbehaviour, or a legal regime that permits such behaviour, which reduces the share price will reduce the manager's personal wealth, which in turn incentivizes the manager to credibly commit to behaving well or subjecting himself to a set of rules that ensures good behaviour. Of course, if the agency costs are worth more to the manager than the decline in the value of this remuneration then he will be neither deterred from incurring those costs nor incentivized to subject himself to legal rules that prevent the incurrence of such costs. The company's competitiveness may be detrimentally affected if, as a result of the incorporation of this information into the share price, raising additional equity capital is more expensive than it otherwise would have been. However, this disciplinary device will be ineffective if the size of the agency costs or potential agency costs, although significant for the individual managers, are immaterial compared to the value of the company.

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<sup>14</sup> Chapter 3, p86.

Clearly, to assess the importance of the disciplinary effects of the above mechanisms, we need to determine whether the efficient capital markets hypothesis is an empirical reality or just an attractive theoretical idea. These disciplinary devices pivot on the validity of the hypothesis as an empirical fact. However, whether the hypothesis reflects reality as well as financial economic theory could take up a whole book and we cannot hope to provide a definitive answer here. At best a few basic observations can be offered. Certainly events in the financial markets over the past decade would not appear to support the efficient markets idea. Both the technology bubble in the late 1990s and the recent credit crisis involved considerable volatility in stock prices and a widely-held perception among sophisticated market participants<sup>15</sup> and the financial press that markets were inaccurately pricing available information. However, the commitment of many scholars to this idea has weathered previous episodes of such volatility (see for example the stock market 'crash' of 1987),<sup>16</sup> although it is important to note in this regard that such episodes have spawned significant nuances and adjustments to the hypothesis.<sup>17</sup> Economists themselves remain divided; a recent commentary on the hypothesis observes that:<sup>18</sup>

[The efficient market's hypothesis is] one of the most hotly contested propositions in all the social sciences. It is disarmingly simple to state, has far-reaching consequences for academic theories and business practice, and yet is surprisingly resilient to empirical proof or refutation. Even after several decades of research and literally thousands of published studies, economists have not yet reached a consensus about whether markets – particularly financial markets – are, in fact, efficient.

It is noteworthy, however, that while many economists and other commentators harbour doubts about the efficient markets hypothesis in relation to the incorporation of fundamental financial and business information, additional doubts plague the hypothesis in relation to the evaluation of legal rules, the scope to which rules enable agency costs, and the actual existence and likely incurrence of agency costs by incumbent management. As we have seen, the legal rules that regulate the governance of the company, as well as the rules that determine their enforcement, are very complicated. Do we really think that market participants, no matter how smart, who typically have no legal training, pay attention to and can understand the implications and operation of these rules? As we saw in Chapter 3, Easterbrook and Fischel think that they can and do. But is such an assumption plausible? Are even the smartest of the smart investors likely to be this smart?

<sup>15</sup> See, for example, G. Soros, *The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What it Means* (Public Affairs, 2008).

<sup>16</sup> On the critique of the efficient markets hypothesis generated by the 1987 crash see R.J. Shiller, *Market Volatility* (MIT, 1990). On post-87 support for the hypothesis see for example, J. Gordon, 'The Mandatory Structure of Corporate Law' (1989) 89 *Columbia Law Review* 1549 noting that 'current practice supports the view that investors do attend to significant variations in charter provisions [the corporate constitution] no less than traditional finance or business information'; R. Romano, 'Empowering Investors: A Market Approach to Securities Regulation' (1998) 107 *Yale Law Journal* 2359 noting that capital markets 'ensure that the contents of legal regimes will be impounded in the cost of capital'.

<sup>17</sup> For example, 'noise theory' on which see L. Summers, 'Does the Market Rationally Reflect Fundamental Values?' (1986) 41 *Journal of Finance* 601; B. De Long, A. Achleifer, L. Summers, R. Waldman, 'Noise Trade Risks in Financial Markets' (1990) 98 *Journal of Political Economy* 703.

<sup>18</sup> A. Lo, 'Efficient Markets Hypothesis' in L. Blume and S. Durlauf, *The New Palgrave: A Dictionary of Economics* (2nd edn, Palgrave Macmillan, 2007).

One response to doubts about such Herculean assumptions, is that such assumptions are not necessary. It may be the case that investors do not value legal rules and the agency cost implications accurately or perfectly assess the costs to the company of actual self-interested behaviour taken by management. What counts is that any such behaviour, or behaviour that can be interpreted problematically, will result in a discount to the share price. If a pattern of disloyalty is seen in companies that are subject to a particular legal regime, then all companies subject to the regime are likely to find that their shares are discounted on the basis of a rough assessment that such regimes enable the incurrence of agency costs. Efficiency may not be perfect but only relative. But that is not to say that the effects of legal rules and the effects of managerial behaviour will not affect the share price of the company.

## 2 *The market for corporate control*

Assuming that capital markets are efficient, or at least relatively efficient, managers who use corporate power to directly or indirectly benefit themselves or shirk and prioritize their personal life over their professional obligations lower the value of the company and its share price. This value delta – the difference between the traded value of the share and the value of the share without a discount to take account of such costs – represents a profit-making opportunity for potential bidders for the company, who could make an offer to buy the shares in the company, take control of the company, and remove self-serving management. Incompetent management similarly lowers the value of the shares and represents an opportunity for potential bidders. A premium paid to shareholders by the bidder to persuade them to sell their shares may, among others, represent a portion of this value delta. The market for corporate control thereby both disincentivizes agency costs and incompetence (by making it more likely that bad managers lose their jobs) and ensures that existing shareholders do not bear the full extent of these costs. Through this frame, senior management's poor behaviour generates a threat to their own employment and the benefits this employment provides to them. Accordingly, the more active the market for corporate control the less scope for managerial agency costs and the lower the likelihood that incompetent management survives. This theory is often attributed to Professor Henry Manne from the following article.

### **H.G. Manne, 'Mergers and the Market for Corporate Control' (1965) 73 *Journal of Political Economy* 110**

#### **The corporate control market**

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The basic proposition advanced in this paper is that the control of corporations may constitute a valuable asset... that an active market for corporate control exists; and that a great many mergers are probably the result of the successful workings of this special market.

Basically this paper will constitute an introduction to a study of the market for corporation control... [which] has important implications for a variety of economic questions. Perhaps the most important implications are those for the alleged separation of ownership and control in large corporations. So long as we are unable to discern any control relationship between small shareholders and corporate management, the thrust of Berle and Means's famous phrase ['the separation of ownership and control'] remains strong. But, as will be explained below, the market for corporate control gives to these shareholders both power and protection commensurate with their interest in corporate affairs.

A fundamental premise underlying the market for corporate control is the existence of a high positive correlation between corporate managerial efficiency and the market price of shares of that company. As an existing company is poorly managed – in the sense of not making as great a return for the shareholders as could be accomplished under other feasible managements – the market price of the shares declines relative to the shares of

other companies in the same industry or relative to the market as a whole. This phenomenon has a dual importance for the market for corporate control.

In the first place, a lower share price facilitates any effort to take over high paying managerial positions. The compensation from these positions may take the usual forms of salary, bonuses, pensions, expense accounts, and stock options. Perhaps more important, it may take the form of information useful in trading in the company's shares; or, if that is illegal, information may be exchanged and the trading done in other companies' shares. But it is extremely doubtful that the full compensation recoverable by executives for managing their corporations explains more than a small fraction of outsider attempts to take over control. Takeovers of corporations are too expensive generally to make the 'purchase' of management compensation an attractive proposition.

It is far more likely that a second kind of reward provides the primary motivation for most take-over attempts... Share price, or that part reflecting managerial efficiency, also measures the potential capital gain inherent in the corporate stock. The lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe that they can manage the company more efficiently. And the potential return from the successful takeover and revitalization of a poorly run company can be enormous... But the greatest benefits of the takeover scheme probably inure to those least conscious of it. Apart from the stock market, we have no objective standard of managerial efficiency. Courts, as indicated by the so-called business judgment rule, are loath to second-guess business decisions or remove directors from office. Only the take-over scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders. Compared to this mechanism, the efforts of... the courts to protect shareholders through the development of a fiduciary duty concept and the shareholder's derivative suit seem small indeed. It is true that sales by dissatisfied shareholders are necessary to trigger the mechanism and that these shareholders may suffer considerable losses. On the other hand, even greater capital losses are prevented by the existence of a competitive market for corporate control.

For Manne, if the behaviour and competence of managers lowers the price of a company's shares then market participants, which we will call control entrepreneurs, will identify an opportunity to take over the company for less than it would be worth under superior management. Manne observes that the effective operation of this market depends upon the efficient market hypothesis being empirically accurate, so that the share price incorporates information about management's failings enabling control entrepreneurs to identify potential targets that would fare better under new management.

You will see from the extract above that Manne focuses on the poor management of companies, and does not distinguish between incompetent management and competent managers who incur agency costs to the shareholders' detriment. A widely held view is that the market for corporate control operates in both respects to incentivize managers to do their best within their capability constraint and to disincentivize managers from acting in their own interests to the detriment of the company. In this regard consider the following extract:

**F.H. Easterbrook and D.R. Fischel, *The Economic Structure of Corporate Law* (Harvard, 1991) 112**

Managers do not always maximize the wealth of investors. We have already discussed the costs of principal-agent relationships. Because managers have only a small stake in the fortunes of the firm, these costs may be quite high. Managers may not work as hard as they would if they could claim a higher share of the proceeds – they may consume excessive perquisites, and they may select inferior projects for the firm without bearing the consequences of their action. Corporate control transactions can reduce agency



costs if better managers obtain control of the firm's assets or if they alter the incentive structure facing existing managers.

With regard to whether, for the reasons set out above, the market for corporate control operates in practice to reduce agency costs some further practical considerations need to be taken into account. Control transactions are expensive for the bidder in terms of both direct costs and opportunity costs. In order for the market for corporate control to actively police managerial agency costs the current market value of the company plus the agency costs must be greater than the costs of acquiring the company (including the amount paid for the shares and the transaction costs involved in purchasing the shares). Consider the following example.

### Example A

The Shares in Bob's Electronics Plc are currently trading at £10 per share and there are 100,000 issued shares. It is well known in the market place that Bob, as CEO, acts in many ways to further his own interests at the expense of shareholder value. This includes, in particular, excessive salary and perquisites. It is estimated these agency costs amount to £2 a share. Matt is a control entrepreneur who runs a small private equity fund specializing in takeovers of small companies. He is interested in acquiring Bob's Electronics Plc. The shareholders will not part with their shares at the current price which means Matt will have to offer a premium to the current price. He concludes that such a premium will have to be £1 a share. In addition, there are direct transaction costs associated with paying his lawyers and financial advisors. These are estimated to be £120,000. Does it make economic sense for Matt to buy the company?

The company has a market capitalization of £1 million. However the company's value to an outside buyer is £1,200,000 (current market capitalization plus the value of the agency costs). If Matt has to pay £11 a share and £120,000 of transaction costs he will be paying £1,220,000 for a company worth £1,200,000. This makes no sense and the takeover will not go ahead. Accordingly, whether the market for corporate control can act as a disciplinary device depends on whether the agency costs are big enough to cover the costs of the deal and the transaction costs. In practice, therefore, the costs of control transactions create some scope for managers to incur agency costs although they may set an upper limit on these costs.

In this regard, consider the following extract.

### **J. Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment Of The Tender Offer's Role in Corporate Governance' (1984) 84 *Columbia Law Review* 1145**

#### **A. The Limits of Market Discipline**

Early in one of their provocative articles, Professors Easterbrook and Fischel state the case for the disciplinary effect of hostile takeovers in bald and unqualified terms: 'The tender bidding process polices managers... and disciplines or replaces them if they stray too far from the service of the shareholders.'<sup>19</sup> But how far is 'too far'? Most instances of managerial inefficiency or self-dealing will not result in a significant enough discount in the corporation's shares to justify the substantial tender offer premiums that have recently prevailed. Surveys have reported that the average premium in cash tender offers during some recent periods has exceeded the stock market price of the target's stock prior to the announcement of the offer by as much as seventy percent. A rational bidder will offer such a premium over the market price (and

<sup>19</sup> F. Easterbrook and D. Fischel, 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94 *Harvard Law Review* 1161.

incur notoriously high transaction costs as well) only if it believes that the future value of the target's stock under different management will exceed the price it offered the target's shareholders within a relatively brief period. Accordingly, before a takeover would be cost-justified, the management of a target corporation would either have to have dissipated the greater portion of the company's value through inefficient performance or self-dealing or have convinced the market that recurrent substantial deviations from the goal of shareholder profit maximization were likely for the foreseeable future.

Whatever the plausibility of this scenario as it might apply to simply inept or overly risk-averse managements, it clearly has limited relevance to the problem of self-dealing. To believe that the tender offer<sup>20</sup> can discipline self-dealing when the typical tender offer premium exceeds fifty percent requires one also to believe that management had first misappropriated a sufficiently large proportion of the corporation's value to cause the market to discount the corporation's shares by more than half. No matter how venal or self-interested the management, such a thorough-going looting seems highly unlikely today in the case of a public corporation living in an environment of constant disclosure and subject to both public and private enforcement. Not only are the numbers involved simply too immense and case histories of abuse on such a scale extraordinarily rare, but there is also a timing problem that makes hostile takeovers largely irrelevant to the problem of self-dealing. The discount in the target corporation's shares should attract a bidder only if the damage to the target is reversible. Yet, the losses caused by a self-dealing management can seldom be restored. Once the horse is stolen, it does little good to buy the empty barn at a premium.

Whilst agency costs alone are unlikely to be large enough to instigate a bid, it is of course true that their existence, to the extent that they can be accurately assessed by a potential control entrepreneur, decreases the value of the company and therefore enhances the attractiveness of the company to a control entrepreneur attracted to a takeover of the company for other reasons. Such other reasons could include, for example, the additional skills, connections and networks that the bidder can bring to the company, or the **synergies** that bringing the target and the bidder together could generate. The point here is that although agency costs *alone* will not in most instances trigger a control transaction, because their existence may make bids instigated for other reasons more attractive the market for corporate control does operate as a break on such agency costs.

The reduction in a company's value as a result of managerial incompetence or ineffectiveness may, however, be much more significant than the reduction generated by agency costs. In this regard consider further Professor Coffee's views.

**J. Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 *Columbia Law Review* 1145**

If the disciplinary capacity of the takeover thus seems irrelevant to the context of self-dealing transactions, its ability to remedy inefficiency is more realistic. Here, it is not implausible that the market might discount the target corporation's shares by a margin greater than the tender offer premium because of managerial ineptitude. Yet, even within this more limited context, two problems remain with the Disciplinary Hypothesis.

First, the hostile bidder, as an external monitor, is unlikely to be the first to detect or respond to managerial inefficiency. Generally, there should be an earlier tripwire –

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<sup>20</sup> 'Tender offer' is the US term for a contractual offer to buy all or part of the company's issued shares. The term used in the UK for such an offer to buy all the company's shares is a 'takeover offer'. On the meaning of 'tender offer' in the UK see fn 25.

namely, internal monitoring within the firm, leading in the case of inefficiency by senior management to their removal by increasingly independent boards of directors, who may have been pressured into action by dissatisfied shareholders or, ultimately, apprehensive creditors. So long as the takeover premium necessary to acquire control is high, one must ask why a minimally independent board would not first detect the inadequacy of the incumbent managers and intervene at a point well before a takeover at a substantial premium became cost-justified. To be sure, one may be justly skeptical about the independence of outside directors in many instances. But even those most critical of the board's performance have acknowledged that the board has consistently performed one essential function – that of crisis intervention, once management's inability to continue has become evident... In principle, the board has far better access to confidential information about the company than does a hostile bidder, and thus it should be aware of managerial inadequacies well before the market has sufficient evidence of them to discount the corporation's shares by a margin sufficient to trigger a takeover. In addition, the palace revolution should be less costly than the full scale attack launched by outsiders.

Phrased more generally, it seems likely that a truly independent board would not tolerate suboptimal performance by management resulting in a share discount large enough to elicit a takeover at any historically prevailing premium level. Of course, some boards are neither independent nor adequately informed, nor do most boards have the same economic incentives to search for mismanagement. Thus, they may passively tolerate substantial inefficiency. This possibility aside, however, the critical point remains that the hostile takeover is at best a failsafe remedy that should come into play only when the board, as the first tripwire, fails to act. This raises a further problem: What happens when internal reform begins to revitalize a company? Even an efficient market's reaction could be slow and hesitant, because the market simply lacks enough information to know if prior errors can be reversed under new management. Not infrequently, a takeover follows such palace coups, and in these instances it may be a superfluous remedy that can actually retard the pace at which the target corporation can be revitalized.

The second basic problem with the Disciplinary Hypothesis is its failure to deal adequately with the problem of risk. Because the bidder pays a premium to acquire the target and, after the acquisition may hold a less diversified portfolio, it incurs a higher level of risk than the ordinary investor... Financially distressed firms appear relatively immune to takeovers, either because no turnaround seems likely or because the level of risk associated with these companies makes them unattractive candidates for acquisition. Ironically, truly sick companies – or at least those whose problems do not appear to be easily remedied – become indigestible and survive, immune from attack precisely because of their pervasive inefficiency.

This conclusion suggests that the discipline of the capital market operates only within a limited range. Basically, this range is bounded, on one end, by the bidder's level of risk aversion and, on the other, by the minimum premium necessary to acquire control. Companies in which the level of inefficiency is either not extreme enough to justify the necessary premium or so extreme as to surpass the bidder's level of risk aversion fall outside this range and may therefore be only weakly disciplined by the market for corporate control.

For Coffee, although the reduction in a company's shares arising from managerial incompetence or ineffectiveness is potentially significant, in his view where the managerial inefficiency is extreme enough to incentivize a bid other corporate governance mechanisms may well be triggered before a bidder arises on the scene. Furthermore, where the incompetence and ineffectiveness destroys so much value that the company is at risk of failing, the extreme risks associated with such a takeover are likely to deter potential control entrepreneurs. For Coffee, therefore, we should expect the market for corporate control to

play in practice only a limited disciplinary role in relation to both managerial agency costs and managerial incompetence. Empirical evidence from the UK seems to support this view.

**J. Franks and C. Mayer, 'Hostile Takeovers and the Correction of Managerial Failure' (1986) 40 *Journal of Financial Economics* 163**

This paper examines whether hostile takeovers act as a discipline on management. Evidence comes from the performance of targets of hostile takeovers before, during, and after acquisition. We report that hostile takeovers are associated with high levels of boardroom changes, higher in hostile than accepted bids and higher in targets of successful than unsuccessful hostile bids. There are also larger... bid premiums in hostile takeovers. However, targets of hostile takeovers do not perform worse prior to bids than either targets of other acquisitions or non-merging firms... There is no evidence of either high bid premiums or poor pre-bid performance when takeovers involve managerial control changes. The market for corporate control does not therefore function as a disciplinary device for poorly performing companies.

## II Basic control transaction structures

A control transaction is a transaction that involves a person obtaining control over the assets of another company. Control could be obtained in three distinct ways: through an asset sale, a share purchase or through a merger.

### 1 Asset sales

An asset sale is quite simply the sale of the company's assets to another person. Legally it is indistinguishable from the sale of single assets or products by the company to a third party, such as the sale of a computer by our case study company, Bob's Electronics Plc. It is just more significant in terms of the number of assets and asset types and the legal complexity involved in identifying and transferring such assets. Sales of all the company's assets will also, typically, involve the transfer of certain related liabilities that will be assumed by the bidder.

As an asset sale is legally identical to the sale of any individual company asset or product, to understand how such a sale would be implemented we need to understand the distribution of authority within the company to effect such sales and the regulation in UK company law of the sales of significant assets.

The board of directors of a company with Model Articles has the power and authority to sell all the company's assets.<sup>21</sup> In the absence of any explicit reservation of power for the shareholder body, the shareholders do not have any veto over the sale of the assets, although they have the ability to instruct the board not to enter into the transaction or to enter into the transaction, if a special resolution to that effect is passed in general meeting.<sup>22</sup>

As we considered in Chapter 6, for listed companies subject to the UKLA's Listing Rules, where the transaction in question involves assets worth 25% or more of the company's value, shareholder approval is required before the company can enter into the transaction.<sup>23</sup> If the

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<sup>21</sup> Article 3 of the Model Articles of Public Companies and the Model Articles for Private Companies, respectively.

<sup>22</sup> Article 4 of the Model Articles of Public Companies and the Model Articles for Private Companies, respectively.

<sup>23</sup> Listing Rule 10. The 25% value is determined by reference to several valuation techniques including comparing the value of the assets being sold (or the consideration

acquiring individual or company is also a shareholder in the selling company then the related party regulation set out in Listing Rule 11 applies requiring separate related party shareholder approval in relation to which the acquiring shareholder and his associates cannot vote. For further details on related party approvals see Chapter 16.

In large companies an asset sale can be a rather cumbersome way of obtaining control over a target company's assets. Many of the assets that have to be sold will include rights under contracts and licences that may not be transferable at all or transferable only with the consent of the counter-party to the contract or the licensing authority. These commercial law problems will not concern us further here. It should be noted, however, that while these problems may also arise in the context of the other structures considered below, they are typically more extensive in the context of an asset sale.

Other non-contractual approvals that may apply to an asset sale include, most importantly, regulatory approvals. For example, to ensure that the asset sale does not have any anti-competitive effects certain approvals may, depending on the nature of the transaction, have to be obtained from either UK or EU competition authorities.<sup>24</sup> Other regulatory approvals may have to be obtained in certain specific industries, for example banking or telecommunications. Such approval requirements are relevant to all control transaction structures discussed in this section.

## 2 Share sales

As the term suggests, a share sale involves the sale by a company's shareholders of their shares in the company. It does not require any action by or on behalf of the company whose shares are being purchased (the target company) apart from the recording of the transaction and the new member of the company in the company's register of members. The company as an entity is unaffected by the sale of the shares. Its assets and activities are unaltered by the fact of the share sale itself, although it may, depending on the new controller's intentions, be subject to significant reorganization after the share sale.

A basic but important observation to be made about a share sale is that it can be pursued and implemented by a bidder without the support of the directors of the target company. This enables control transactions implemented through a share sale to be 'hostile' or 'unsolicited', that is, opposed and unwanted by target company management. The vast majority of share sales are, however, not hostile transactions but friendly transactions that have the full support of target management. Effecting the transaction through the share sale route is widely viewed in the UK as the most effective and efficient means of obtaining control.

Share sales are the most common form of control transaction for listed companies in the UK. They are typically referred to as 'takeovers'. Another term which one should be aware of in this regard is 'tender offer' which in the UK is an offer to purchase up to, but not more than, 30% of the company's issued shares for cash.<sup>25</sup> In the US the term 'tender offer' is the generic term for a share sale takeover regardless of the percentage of shares sought or the consideration offered. Typically a takeover is implemented by a contractual offer: a direct offer

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paid) to the company's profits, its gross assets or market capitalization. For a more precise understanding of these valuation techniques see Listing Rule 10 Annex 1.1.

<sup>24</sup> See generally, D. Chalmers et al, *European Union Law: Text and Materials* (CUP, 2006), ch 21; R. Whish, *Competition Law* (6th edn, 2008), chs 20–22.

<sup>25</sup> A 'tender offer' for the purposes of the Takeover Code is an offer type that although requiring Panel consent will normally be allowed. Its key elements are an offer for less than 30% of the shares (or from a more than 50% shareholder for a proportion of the minority holding) and the offer must be in cash. The regulation of tender offers is set out in Appendix 5 of the Takeover Code.

by the bidder to the shareholders of the target. However, in the UK it is also possible to effect a share sale through a process which does not involve a direct contractual offer to the shareholders to buy the shares. The mechanism for effecting such a sale is called a *scheme of arrangement* and will be considered in detail in Part C of this chapter below.

Although target company approvals are not required to implement a share sale, and although no company assets are transferred as a result of the takeover, it may be necessary to obtain approvals from some of the target company's contractual counterparties and applicable regulatory authorities. In relation to the former, it is not uncommon for contracts to contain 'change of control' provisions that affect the validity of the contract should there be a 'change of control' in the company's shareholder body. What amounts to a 'change of control' would typically be defined in the relevant contract. Approval requirements also typically apply to any regulatory licences, such as banking or telecommunications licences. Other regulatory approvals could include approvals from competition authorities. Furthermore, the takeover may, depending on its value and the consideration paid by the bidder, require certain bidder approvals. For example, if the consideration paid consists of bidder shares then the bidder company will require authorization to allot the shares if the existing allotment authorization is insufficient.<sup>26</sup> If the bidder is a listed company and the transaction crosses Listing Rule 10's 25% Class 1<sup>27</sup> value threshold it also requires *bidder* shareholder approval.

### 3 Mergers

As we saw above, in an asset sale the company transfers its assets, and certain of its liabilities, to a third party in exchange for the consideration paid for those assets. After the transaction the company may be an empty shell holding only the consideration and nothing more. However, the target company continues as a separate legal person, although it may well be wound up and dissolved shortly thereafter. By contrast, where two companies wish to merge, the assets of one of the merging companies will be, as a result of the merger, transferred to the other company (the surviving company) *by operation of law* and the transferring company's existence will come to an end; it will have been merged into the surviving company. In contrast to an asset sale, therefore, there is no need to provide for the transfer of each asset, the assets are transferred by operation of law. That is, the law deems them to have been transferred, to the extent that such transfer is possible without the consent of any contractual counterparties or regulatory authorities.

Most jurisdictions provide for a statutory merger mechanism, typically providing for merger following the obtaining of specified board and shareholder approvals from all the merging companies. The UK does not provide for such a statutory merger mechanism although it does provide for the merger of companies through a *scheme of arrangement* which we shall consider in detail in Part C of this chapter below.

#### Questions:

1. How can the product market constrain managerial misbehaviour? Is it likely to do so in practice?
2. Is the market in managerial and director services likely to operate to limit the scope for incurrence of managerial agency costs?
3. What is the efficient capital markets hypothesis and what is its relevance to company law?

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<sup>26</sup> Sections 549–551 Companies Act 2006. Note that no waiver of pre-emption rights will be required as pre-emption rights are inapplicable where the consideration for the allotment is non-cash consideration (section 565 Companies Act 2006).

<sup>27</sup> Listing Rule 10.2.2 and Annex 1.

4. How, *in theory*, does the market for corporate control operate to discipline managerial self interest and incompetence?
5. Is the notion that the market for corporate control acts as a break on the managerial agency fees a theoretical pipedream or does it have some practical resonance?

## B: THE REGULATION OF THE MARKET FOR CORPORATE CONTROL

### I The Takeover Panel

#### 1 *The genesis of the Panel on Takeovers and Mergers and the City Code on Takeovers and Mergers*

As will be clear from A.II above, the simplest way of obtaining control over a company is to make an offer to the existing target shareholders to buy their shares. If the shareholders accept the offer the shares will be transferred to the bidder in exchange for the agreed consideration. English company law has traditionally had *nothing* to say about the form of or the way in which that offer is made. The parties to the potential contract of exchange were free to structure the nature of the offer and the acceptance or rejection of the offer at their discretion. To the extent that such a contractual transfer of shares was subject to restrictions, those restrictions would be found in the target company's constitution. Typical constitutional restrictions would include a right of first refusal for the other non-selling shareholders, or a right for the board of directors to refuse, at their discretion, to enter the transferee shareholder in the register of members.<sup>28</sup> In the absence of such restrictions the share sale would be governed by the law of contract and the law regulating the formal transfer of the share.<sup>29</sup>

In the absence of any restrictions on the transfer of shares in a company's constitution, the decision whether to accept the offer made by the bidder or to reject it is a decision for the owner of the share to make. That is, there is no company law requirement to obtain board or general meeting approval for the sale to go ahead; there is no veto or approval right for any corporate body. However, whilst company law does not empower any corporate body to veto the share transfer, obviously the sale of the shares and the transfer of control has profound implications for: (1) the company, its strategy and direction; (2) those who control and run the company – its directors and the managers; and (3) those who elect not to sell their shares – the minority shareholders. Managers may lose their jobs following the change of control; minority shareholders will now be members of a company with an unknown, possibly unfriendly, controlling shareholder. However, although company law does not directly empower any corporate organ or agent with a right of approval or veto over the share transfer, there are many indirect ways in which corporate power can be used to 'protect' the concerns and interests of the company, the board and management, and the minority shareholders. Indeed, in Chapter 11, when we considered the duty to use powers for the purposes for which they have been conferred set out in section 171(b) of the Companies Act 2006, we saw corporate powers being explicitly used in *Hogg v Cramphorn*<sup>30</sup> to prevent a hostile bid by issuing shares and a loan to a friendly trust set up by the company. Below in

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<sup>28</sup> See, for example, *Re The Coalport China Co (John Rose and Co) Ltd* [1895–9] All ER Rep Ext 2021 and *Re Cawley & Co* (1889) 42 Ch D 209. The transferee shareholder does not become a member until he is entered in the register of members (section 112(2) Companies Act 2006).

<sup>29</sup> See P. Davies, *Gower and Davies' Principles of Modern Company Law* (8th edn, 2008), ch 27.

<sup>30</sup> [1967] Ch 254.



section IV we shall address further the contemporary regulation of the use of corporate power to frustrate a bid.

In the 1950s and 1960s such conflicts generated by hostile bids, and the use by target boards of corporate powers to attempt to frustrate these bids, came increasingly to the fore of media and governmental attention as a result of several high profile hostile bids for companies listed on the London Stock Exchange. These takeover battles acted as the catalyst for the regulation of takeovers of listed companies by what is known today as the City Code on Takeovers and Mergers, which we shall refer to hereafter as 'the Takeover Code'. The Takeover Code, whose development we consider in detail below, was formed in the crucible of such conflicts but importantly, as we shall see, its regulatory reach extended far beyond the conflicts which gave rise to its birth. In this regard consider the following extract.

**J. Armour and D. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 *Georgetown Law Journal* 1727<sup>31</sup>**

The history of hostile takeovers in the United Kingdom began in the early 1950s... The first successful bid, Charles Clore's takeover of shoe retailer J. Sears in early 1953, is a good illustration. Clore realized that, owing to inflation, Sears's portfolio of city center premises was substantially undervalued in its accounts. Yet because investors' valuation [of the company]... were largely based on dividend yields, this was not reflected in its share price. To exploit this, Clore made a [takeover] offer directly to shareholders. It was considered very sharp practice and came as an enormous shock for the company's management and the City establishment in general. The Sears board promised to increase dividends and to revalue the firm's property to reflect its higher current value. But for the company's shareholders, this was too little, too late. A large majority accepted Clore's offer...

Much of the British business community was initially outraged by the advent of the takeover bid and believed that takeovers were harmful for industry. Managers initially felt justified in defending themselves, as is illustrated by the notorious battle for Savoy Hotel Ltd. This began later in 1953, when Harold Samuel, another financier specializing in takeovers, started buying that company's shares. Samuel intended to convert the Savoy's Berkeley Hotel into commercial offices. The Savoy board responded... [by arranging] for the Berkeley Hotel to be sold to a new entity, Worcester (London) Co. Ltd., and leased back to Savoy on terms that required the building to be used only as a hotel. The voting shares in Worcester were allotted to the trustees of Savoy's pension fund – one of whom, conveniently, was chairman of its board. There was thus no way that Samuel could convert the hotel into offices even if he succeeded in ousting the incumbent board.

The Savoy board's tactics were highly controversial because their shareholders were given no say in the bid's outcome. The subsequent outcry led the United Kingdom's Board of Trade to investigate the directors' conduct. The Board's report was prepared by E. Milner Holland Q.C., a leading company law barrister. Milner Holland concluded that the Savoy directors had overstepped the mark because, although they had acted in good faith, the effect of the scheme was to 'disable [stockholders] from varying the decision of the [b]oard.' However, his report lacked the binding force of a court judgment; indeed, the Savoy board had taken advice from another leading barrister to

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<sup>31</sup> The final text of the Georgetown Law Journal article is available here: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=928928](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928928). See further Sir A. Johnston, *The Takeover Code* (1980) and A. Johnson, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66(2) *Cambridge Law Journal* 422–60.

the effect that their scheme was perfectly lawful.<sup>32</sup> Direct precedents on the point were non-existent.

It was against this background of controversy that the notorious battle for British Aluminium played out. At the end of 1958, the managers of British Aluminium Ltd. ('BA') were approached by two rival camps: one from the US Reynolds Metal Company in partnership with UK-based Tube Investments ('TI-Reynolds'), and the other from the Aluminium Company of America ('Alcoa'). Without informing their shareholders of these developments, BA's board rejected TI-Reynolds's approach, instead agreeing to a deal with Alcoa under which the latter was issued with new shares amounting to a one-third stake in BA.<sup>33</sup> It was only when TI-Reynolds made clear that they intended to go over the BA directors' heads with an offer directly to the shareholders that the directors publicly revealed the Alcoa deal. The BA board then tried to bribe their shareholders with a generous dividend increase, which boosted the share price considerably. This, however, only served to provoke further anger that Alcoa had been permitted to buy a large block of shares at the earlier-undervalued-price. Shareholders' response was quick and devastating: they dumped BA stock as fast as TI-Reynolds could buy it, thereby sealing the incumbent management's fate.

The BA board's conduct provoked widespread calls for takeover regulation. In July 1959, the Governor of the Bank of England secretly invited a committee comprised of trade groups representing merchant banks, institutional investors, the largest commercial banks, and the London Stock Exchange to devise a code of conduct to regulate takeover bids. This initiative seems to have been prompted, at least in part, by the fear that if action did not appear to have been taken, the matter would be taken out of the City's hands by legislation. Indeed, shortly afterwards, Prime Minister Harold Macmillan announced a review of the working of company law, including takeovers.

In the autumn of 1959, the Bank's committee announced the *Notes on Amalgamation of British Businesses*. The *Notes* contained a series of general guidelines that were 'concerned primarily to safeguard the interests of shareholders.' The first of the *Notes*' four main principles stated that there should be no interference with the free market in shares, and the second that it was to be for the shareholder himself to decide whether to sell. The *Notes* also called for shareholders to be given enough information to make an intelligent decision, and enough time to digest it. The principle of shareholder primacy – and correlative board neutrality – was thus established. In keeping with the gentlemanly spirit in which the City did business at the time, the principles established by the *Notes* were dubbed the 'Queensberry Rules,' after the rules drafted by the Marquess of Queensberry to regulate prize-fighting. The Bank of England's circulation of the *Notes* seemed to have the effect of heading off demands for legislative intervention.

Although the *Notes* were generally well-received, and were revised and improved in 1963, their influence on the UK takeover market was limited by the lack of mechanisms for adjudication and enforcement. Things came to a head in 1967, when in a battle between two bidders for control of Metal Industries Ltd. ('MI'), a third party bought a block of shares in the market and sold these to one of the bidders – enough to

<sup>32</sup> Note that this is 1953. The common law position articulated in *Hogg v Cramphorn* [1967] Ch 254 and *Howard Smith Ltd v Ampol* [1974] AC 821 would not, it is submitted, view these actions as lawful. See further Chapter 11.

<sup>33</sup> Note that at this time, unless provided for in a company's constitution, companies did not have to obtain authority to allot and shareholders did not benefit from pre-emption rights as they do today. See further Chapter 17.

secure control. Enough, that was, until MI's board responded by issuing fresh shares to the other bidder – the very tactic that had provoked outrage in the case of British Aluminium. By the summer of 1967, *The Economist* concluded that the widespread evasion of the *Notes*' principles made them 'a dead letter'.

The financial press suggested that the only hope for a well-functioning takeover market would be a governmental agency with oversight authority, along the lines of the [US's state regulatory authority the Securities and Exchange Commission (the 'SEC')]. But a British SEC was not to be. In July 1967, Prime Minister Harold Wilson insisted that statutory rules were not the answer. Within days, the Bank of England's Working Party had reconvened to begin drafting a new set of takeover rules. By the end of March 1968... the draft *Takeover Code* was ready. The new *Code* was very much in the same shareholder-oriented spirit as the earlier *Notes*, but its form was more specific. It consisted of a series of ten general principles, instantiated in thirty-five specific rules. Not surprisingly, many of its details could be traced to the problems that had surfaced in the takeover transactions of the previous years. The basic principle of shareholder choice, taken from the *Notes*, was now supplemented by a general ban on frustrating actions and specific prohibitions of transactions likely to induce this – issuing shares, disposing of material assets or entering into a significant contract – without the approval of the shareholders. Similarly specific requirements were set out in relation to the equal treatment of shareholders.

For the first time, too, a body of individuals was entrusted with the task of 'adjudicating' disputes about the application of the rules. The City Panel on Takeovers and Mergers was inaugurated on March 27, 1968. Its nine members, who were drawn from the organizations represented on the Working Party, consciously decided that proactive involvement was better than an ex post judicial approach... However, the wholly non-executive Panel seems to have been overwhelmed by the volume of business – 575 cases in its first year – and its responses to several high-profile infringements of the Code were disappointing. *The Economist* complained that aggressive bidders were running a 'coach and horses through the Code' and insisted that the time had come for a 'professional referee' with a full range of legal sanctions at its disposal. Although Prime Minister Harold Wilson announced he had 'no desire to introduce legislation to force on the City the much tougher and more wide-ranging interference which free enterprise America has devised in the form of the Securities and Exchange Commission,' the government made clear that they would be forced to legislate unless the Panel quickly reformed its oversight techniques.

Over the next few months, three major changes were announced that would transform the Panel. First, the Panel was given a full-time executive staff, paid for by City institutions. Lord Shawcross, a political heavyweight who had formerly been both Attorney-General and President of the Board of Trade, was persuaded to serve as non-executive Chairman, and Ian Fraser, an experienced takeover specialist from S.G. Warburg, was recruited as executive Director-General. Secondly, due process protection was added to the Panel's procedures. An Appeal Committee was constituted, the first President of which was a former Law Lord. Finally, and most importantly, the sanctions available to the Panel were dramatically enhanced. These piggybacked on the existing authority of the Stock Exchange and the Board of Trade. The Stock Exchange had the power to censure, suspend or expel a company from the Official List, and the Board of Trade had similar authority over licensed share dealers. Moreover, the various trade associations represented in the Working Party agreed to impose sanctions upon their members – up to and including stripping them of membership – if asked to do so by the Panel. This gave the Panel a range of responses, ranging from public censure through trade association sanctions to complete withdrawal of the right to deal in securities and/or de-listing. The introduction to a subsequent version of the Code made this clear:

‘The Code has not, and does not seek to have, the force of law, but those who wish to take advantage of the facilities of the securities markets in the United Kingdom should conduct themselves in matters relating to take-overs according to the Code. Those who do not so conduct themselves cannot expect to enjoy those facilities and may find that they are withheld.’

The status of the Panel as regulators of U.K. takeovers was cemented by its very firm, but even-handed, response to problems in a 1969 takeover of Pergamon Press by American Leasco Data Processing Equipment Corp. A series of revelations about murky accounting practices and insider dealing at Pergamon, 31% of which was held by Robert Maxwell, gave Leasco cold feet about the deal. The Panel insisted on full disclosure, and asked the Board of Trade to conduct an investigation into Pergamon’s affairs. The Panel’s decisive intervention greatly enhanced its credibility and quieted calls for a British SEC.

Although the Panel’s immediate future was safe, its Chairman, Lord Shawcross, was well aware of how little it would take, especially with the left-leaning Labour governments of the 1970s, to provoke legislative intervention. In his view, the Panel needed to do more than simply to reflect contemporary best practice. If another scandal occurred, critics would simply conclude that ‘best’ practice was not good enough. Rather, it had to ensure that there were no further scandals. To do this, the Panel became involved in the continuous development of *better* practice. It updated its rules proactively in response to developments in the market, in so doing focusing heuristically on the needs of the ‘small shareholder’...

The emergence of the Panel as the principal source of regulatory oversight over U.K. takeovers can hardly be described as an illustration of spontaneous order in action. Rather, it is better characterized as coerced self-regulation, made under a clear governmental threat of intervention.... In the words of a leading English judge, Sir John Donaldson M.R.:

‘The Panel on Take-overs and Mergers is a truly remarkable body. Perched on the 20th floor of the Stock Exchange building in the City of London, both literally and metaphorically it oversees and regulates a very important part of the United Kingdom financial market. Yet it performs this function without visible means of legal support.’

## 2 *The Panel on Takeovers and Mergers today*

### 2.1 From self-regulatory body to supervisory authority

The Takeover Panel is the pre-eminent example of a market regulating itself: the promulgation of rules by market participants which are enforced by market participants without recourse to the enforcement powers of the state. The primary advantage of self-regulation is that the regulator is very closely connected to the regulated activity and, therefore, is very capable of both identifying market activity that requires an adjustment to the rules and responding quickly to implement such adjustments. Such a self-regulator is not constrained by the delays inherent in the democratic legislative process or by the difficulties of getting the attention of the executive.

While such justifications are standard fare in conversations about the benefits of state versus self-regulation, one must be wary of overstating them. A state regulator staffed by former market participants and empowered to change the rules of the game would be able to respond in a similarly informed and timely fashion. Indeed, there is some irony in the fact that while the Takeover Panel remains the standard bearer of the informed and responsive regulator, today it is no longer a pure product of the market’s self-regulation. The reason for this is that the European Union’s Thirteenth Directive on Company Law imposed on all EU Member States the obligation to designate a *supervisory authority* responsible for regulating

takeover bids.<sup>34</sup> The UK Government designated the Takeover Panel as its *supervisory authority*.<sup>35</sup> This designation has not altered the modus operandi of the Panel;<sup>36</sup> however, it does render its authority as a regulator a function of delegated power from the state, rather than the endogenous regulatory product of the market place. As we shall see below, this statutory designation has also resulted in the direct availability to the Panel of the authority of the state for the purposes of enforcing its rules. In practice, however, recourse to such authority is unlikely to take place as the existing self-regulatory enforcement mechanisms will continue to do most of the enforcement work.

The primary problem with self-regulation is that the regulatory product may serve the interests of the regulated group and not adequately take into account the interests of groups affected by the regulated activity but who are not party, directly or indirectly, to deciding on the form and content of the regulation. While the state itself is not immune from being influenced by, or indeed captured by, the interests of the regulated group, it is, obviously, somewhat more removed from, more independent of, the regulated group than the regulated group itself. The 'independence' of the self-regulatory body from the regulated's interests and its willingness to impose regulation that takes account of other interests or the 'public interest' is a central concern if the state accepts a self-regulatory solution. Any self-regulatory body operates within the shadow of this concern and is aware that should its regulation of the regulated group enable the regulated activity to be carried out without due regard for these other interests then the privilege of self-regulation may be displaced by state intervention.

The self-regulatory status of the Takeover Panel has not been displaced as a result of any independence concerns<sup>37</sup> but because of the requirement to implement the EU's Company Law Directive on Takeover Bids.<sup>38</sup> However, although the Takeover Panel, as supervisory authority, has statutory authority to regulate the takeover market, the concern articulated above about regulatory independence remains, as the Panel is now in effect a self-regulatory body in state clothing. Importantly, the Takeover Panel is not as exposed to such 'independence' concerns as other self-regulatory bodies that have, for example, traditionally regulated the accounting and legal professions.<sup>39</sup> The reason for this is that, as we saw in the above extracts and is considered further below, there are several market participants, with at times different interests and objectives, which have played, and continue to play, a role in forming the rules. The regulatory outcomes generated by the Panel mediate these varying

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<sup>34</sup> Directive 2004/25/EC on Takeover Bids, Article 4.

<sup>35</sup> This designation is found in section 942 CA 2006.

<sup>36</sup> The Act gives a broad authority to the Panel. It may 'do anything that it considers necessary or expedient for the purposes of, or in connection with, its functions' (section 942(2) Companies Act 2006).

<sup>37</sup> This contrasts sharply with the move from self-regulation to quasi-state regulation in the accounting and law professions.

<sup>38</sup> 2004/25/EC.

<sup>39</sup> Today these professions are no longer subject to pure self-regulation but to a hybrid of quasi-state and self-regulation. With regard to the accounting profession see Web Chapter B. On the regulation of the legal profession see R. Baldwin, M. Cave, K. Malleson, 'Regulating Legal Services: Time for the Big Bang' (2004) 67 *MLR* 787.

interests. However, some commentators argue persuasively that certain of the Panel's constituencies, in particular institutional investors, have had greater influence than others.<sup>40</sup>

## 2.2 The structure and operation of the Takeover Panel

The members of the Takeover Panel are appointed to one of the two primary committees of the Panel:<sup>41</sup> the Hearings Committee<sup>42</sup> and the Code Committee.<sup>43</sup> The Panel may consist of up to 34 members. Eleven Panel members are appointed by the various bodies that represent the business, investor, banking and advisory constituencies in the market place.<sup>44</sup> The chairman of the Panel, two deputy chairman and up to 20 members are appointed by the Panel on the recommendation of the Panel's nomination committee.<sup>45</sup> These members appointed by the Panel are referred to as the 'independent members'. Each member will on appointment be designated to either the Code Committee or the Hearings Committee. In addition to these two committees the Takeover Panel also has an 'Executive' responsible for the day-to-day work of the Panel.

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<sup>40</sup> J. Armour and D. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 *Georgetown Law Journal* 1727 arguing that institutional investors have exercised a dominant influence over the Takeover Code ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=928928](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928928)).

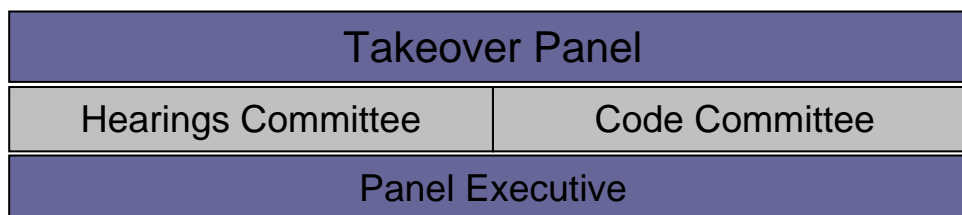
<sup>41</sup> Changes to the structure of the Takeover Panel were made in 2006 in order to comply with the Thirteenth Takeover Directive and the UK implementation thereof, now set out in Part 28 of the 2006 Act.

<sup>42</sup> Section 951 Companies Act 2006 requires the formation of a separate hearings committee. Section 951(5) prevents a member of the Code Committee serving on the Hearings Committee.

<sup>43</sup> Section 943(5) Companies Act 2006 requires the rules making function (apart from in relation to fees – section 943(4)) to be performed by a committee of the Panel.

<sup>44</sup> The nominating bodies are: The Association of British Insurers; The Association of Investment Companies; The Association of Private Client Investment Managers and Stockbrokers; The British Bankers' Association; The Confederation of British Industry; The Institute of Chartered Accountants in England and Wales; The Investment Management Association; The London Investment Banking Association (with separate representation for its Corporate Finance Committee and Securities Trading Committee); The National Association of Pension Funds.

<sup>45</sup> The nomination committee consist of the chairman, a deputy chairman, an independent member from the Hearings Committee and the Code Committee, a member nominated by one of the nominating bodies and a representative from the Bank of England.

**Figure 1: The Takeover Panel**<sup>46</sup>

The Code Committee, which consists of up to 12 members, is *solely*<sup>47</sup> responsible for reviewing, amending and updating the Code. Only 'independent members' appointed by the Panel are appointed to the Code Committee. Ostensibly this gives the impression of independence of the rule makers from the business and capital market constituencies who appoint 11 members of the Panel to the Hearings Committee. However, such 'independence' appears somewhat illusory given that the Code Committee comprises primarily of members who work for one of those constituencies.<sup>48</sup>

The Hearings Committee has several functions. First, it operates as an appeals tribunal for the party who requested and is dissatisfied with the Executive's ruling, or indeed for 'any party with a sufficient interest in the matter'.<sup>49</sup> Such an appeal should be made within a reasonable time and not later than one month from the date of the ruling.<sup>50</sup> Secondly, where the issue in question is 'particularly unusual, important or difficult'<sup>51</sup> the Executive itself may refer the matter to the Hearings Committee. Thirdly, the Executive may commence disciplinary proceedings to be considered by the Hearings Committee where in its view there has been a breach of the Code.<sup>52</sup> The Code observes that Hearing Committee proceedings are 'informal' and are not subject to rules of evidence although the Chairman of the Hearings Committee is empowered to make procedural rulings. It is noteworthy that the Hearings Committee is relatively rarely convened to consider a matter referred to it. For example, in 2008 there was only one Hearings Committee ruling. Note also that when it is convened in relation to a matter of Code interpretation or an Executive ruling it addresses the issue exceptionally quickly. In the one 2008 Hearings Committee ruling in relation to Imperial Energy Corporation Plc, the Executive Ruling was made late on 4 December 2008, an appeal was made on Friday 5

<sup>46</sup> Taken from the Takeover Panel's website at <http://www.thetakeoverpanel.org.uk/structure/about-the-panel/organisation-chart>.

<sup>47</sup> Takeover Code, Introduction, section 4(b).

<sup>48</sup> At the time of writing all but one of the current eight-member Code Committee works for a bank, insurance company or investment company. The exception was a lawyer from a leading City law firm.

<sup>49</sup> Takeover Code, Introduction, section 7(a)(i).

<sup>50</sup> Takeover Code, Introduction, section 7(b).

<sup>51</sup> Takeover Code, Introduction, section 7(a)(ii).

<sup>52</sup> Takeover Code, Introduction, section 7(a)(iii).

December and the hearing took place and the Committee announced its decision on Monday 8 December.<sup>53</sup>

The Panel Executive, which performs 'the day-to-day work of takeover supervision and regulation', is staffed with full-time members and secondees from City law firms, accounting firms, corporate brokers and investment banks. The Director of the Executive is normally a secondee from an investment bank, the three deputy directors are full-time officers of the Executive. The secondees from City institutions are known as 'case officers'. Case officers are available to give 'real time' – that is immediate – views and responses on the questions posed by advisors to companies involved in a bid or a possible bid. The ease of the availability of the case officers to market participants and the willingness of the case officers to give guidance and advice on the interpretation and application of the Takeover Code is viewed as one of the primary advantages of regulating takeovers through the Takeover Panel. The Executive can be approached on a 'no-names' basis to maintain the confidentiality of a potential bid. Typically, it will be a company's investment banker or financial advisor that will approach the Executive for guidance, although the company's legal advisor may do so too. Indeed, a peculiarity of regulation through the Takeover Code and Takeover Panel is that investment banks are the primary guardians of the Code – both in terms of the make up of Panel Committees and the Executive as well as their role as primary advisors on the interpretation and application of the Code. Investment bankers, therefore, in this discrete area of regulation perform the role typically performed by lawyers. The Code itself places particular emphasis on the role of financial advisors in ensuring that their clients comply with the Code:

The Code also applies to all advisers to such persons, and all advisers in so far as they advise on takeovers or other matters to which the Code applies. Financial advisers to whom the Code applies have a particular responsibility to comply with the Code and to ensure, so far as they are reasonably able, that their client and its directors are aware of their responsibilities under the Code and will comply with them and that the Panel is consulted whenever appropriate.<sup>54</sup>

In addition to this specific informal guidance provided by the Executive when approached by a company's advisors, the Executive also periodically publishes practice statements 'which provide informal guidance as to how the Executive usually interprets and applies particular provisions of the Code in certain circumstances'.<sup>55</sup> While market actors may approach the Panel Executive for guidance or take guidance from the practice statements, neither the specific guidance nor the practice statements are binding.<sup>56</sup> To be sure that any particular interpretation or application of the Takeover Code is correct a *ruling* from the Executive should be obtained. In this regard, the Takeover Code provides as follows:<sup>57</sup>

When a person or its advisers are in any doubt whatsoever as to whether a proposed course of conduct is in accordance with the General Principles or the rules, or whenever a waiver or derogation from the application of the provisions of the Code is sought, that person or its advisers must consult the Executive in advance. In this way, they can obtain a conditional ruling (on an ex parte basis) or an unconditional ruling as

<sup>53</sup> Decision of Takeover Panel Hearings Committee, Imperial Energy Corporation Plc 2008/46. (available at [www.thetakeoverpanel.org.uk/wp-content/uploads/2008/12/2008-46.pdf](http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/12/2008-46.pdf)).

<sup>54</sup> Takeover Code, Introduction, section 3(f).

<sup>55</sup> Takeover Code, Introduction, section 6(a).

<sup>56</sup> Takeover Code, Introduction, section 6(a).

<sup>57</sup> Takeover Code, Introduction, section 6(b).



to the basis on which they can properly proceed and thus minimize the risk of taking action which might, in the event, be a breach of the Code. To take legal or other professional advice on the interpretation, application or effect of the Code is not an appropriate alternative to obtaining a ruling from the Executive.

Section 945 of the Act authorizes the Panel to make such rulings 'on the interpretation, application or effect of the rules' and provides that the rulings of the Panel are binding, subject to any review or appeal. Note also that the Act authorises the Panel to 'dispense with or modify the application of rules in particular cases and by reference to any circumstances'.<sup>58</sup> The Code provides that the Panel may exercise this discretion to waive the application of the rule where the application of the rule would 'operate unduly harshly or in an unreasonably restrictive or burdensome or otherwise inappropriate manner'.<sup>59</sup>

The final part of the Takeover Panel structure is the *Takeover Appeal Board*<sup>60</sup> to which any party to a Hearings Committee hearing can appeal against the Hearings Committee's ruling.<sup>61</sup> The Takeover Appeal Board is an independent body separate from the Takeover Panel. The chairman and deputy chairman of the Appeals Board are normally former senior judges. Currently the chairman of the Appeal Board is the retired Law Lord, Lord Steyn and the retired Lord Justice, Sir Martin Nourse is the deputy chairman. An appeal will be before three to five members of the Board. Typically either the chairman or the deputy chairman of the Board will chair the hearing. The Takeover Code empowers the Appeal Board to 'confirm, vary, set aside, annul or replace the contested ruling of the Hearings Committee'.<sup>62</sup> Appeals to the Appeal Board are rare. There has been one appeal in the past three years in relation to a takeover connected to the reorganization of the Eurotunnel Group.<sup>63</sup> As with the Hearings Committee, the speed of the Appeal Board's response is particularly noteworthy. In the Eurotunnel case the Hearings Committee's ruling was made on 11 May 2007, an appeal to the Takeover Appeal Board was made on 14 May and the Appeal Board's ruling was made on 18 May.

As will be clear from the above analysis, the defining features of the structure and organization of the Takeover Panel are first, direct access for market participants to the regulator, and, second, the speed with which the Panel acts in relation to all aspects of its activities: Code reform; the provision of guidance; the making of binding rulings; and the hearing of appeals. Particularly in relation to guidance, rulings and appeals direct access to the Panel and the speed with which the Panel acts enables market participants to obtain a clear understanding of the application of the rules to their particular transaction or possible transaction within a short time frame. This facilitates planning and takeover market activity and is widely appreciated by market participants.

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<sup>58</sup> Section 944(1) CA 2006.

<sup>59</sup> Takeover Code, Introduction section 2(c).

<sup>60</sup> Section 951(3) Companies Act 2006 requires the Takeover Panel rules to provide for a right of appeal to the Takeover Appeal Board.

<sup>61</sup> Rules of the Takeover Appeals Board, Rule 1.1 (available at <http://www.thetakeoverappealboard.org.uk/rules.html>).

<sup>62</sup> Takeover Code, introduction, section 8(c).

<sup>63</sup> Eurotunnel Plc (Takeover Appeals Board 2007/2).

### 3 *Judicial review and the Panel*

Prior to the implementation of the EU's Company Law Directive on Takeovers and the designation of the Takeover Panel as the supervisory authority, the Takeover Panel was not a public body; it was a private body created by the coordinated action of private actors. Nevertheless, in regulating the takeover market place the Panel performed a state/public function. Given this function, a question that arose was whether in addition to the appeal processes set out within the Panel's organizational structure recourse could also be had to judicial review of the Panel's decisions. It is important to note that judicial review of the decision, if allowed, would not operate as another tier of appeal in addition to the Hearings Committee and the Appeals Board. In this regard consider Lord Donaldson MR's observations on the role of the court in *R. v Panel on Takeovers and Mergers, ex p Datafin Plc* [1987] QB 815, considered in detail below.

An application for judicial review is not an appeal. The Panel and not the court is the body charged with the duty of evaluating the evidence and finding the facts. The role of the court is wholly different. It is, in an appropriate case, to review the decision of the Panel and to consider whether there has been 'illegality', i.e., whether the Panel has misdirected itself in law; 'irrationality', i.e., whether the Panel's decision is so outrageous in its defiance of logic or of accepted moral standards that no sensible person who had applied his mind to the question to be decided could have arrived at it; or 'procedural impropriety', i.e., a departure by the Panel from any procedural rules governing its conduct or a failure to observe the basic rules of natural justice, which is probably better described as 'fundamental unfairness', since justice in nature is conspicuous by its absence.

The primary objection to enabling judicial review of the Panel's decisions was that the delays inherent in a court process would wholly undermine the primary benefits of regulation by the Takeover Panel, namely: the speed with which the Panel can respond to enquiries and provide definitive rulings on such enquires – whether as a result of an Executive ruling or the findings of the Hearings Committee or the Appeals Board. This issue was addressed by the Court of Appeal in the *Datafin Case*.

#### ***R v Panel On Takeovers and Mergers, ex p Datafin Plc* [1987] QB 815**

[As we shall discuss in detail in B.II below, the Takeover Code contains a rule requiring that the bidder pays to the shareholders who accept the offer the highest price which he pays for any shares during the offer period and, depending on the nature of the bid, the highest price he has paid over a specified time frame prior to commencing the bid. The rules also prevent the bidder from increasing his offer where he clarifies that the offer is final. These price rules also apply to anyone 'acting in concert' with the bidder. The term acting in concert is a highly defined term – which we shall consider in detail in IV below – which attempts to capture those actors that are acting together with/in conjunction with the bidder. In this case there were two separate bidders for the company (call them Bidder A and Bidder B). Bidder A complained to the Panel that certain parties were acting in concert with Bidder B and, as those parties had paid more for shares during the relevant period than Bidder B, that Bidder B was in breach of the above pricing rules. The Panel rejected the complaint and Bidder A applied for judicial review of this decision. Lord Donaldson MR considered the extent to which the Panel's decision could be subject to judicial review.]

#### **Lord Donaldson MR**

##### ***The jurisdictional issue***

The principal issue in this appeal, and only issue which may matter in the longer term, is whether this remarkable body is above the law. Its respectability is beyond question. So is its bona fides. I do not doubt for one moment that it is intended to, and does,

operate in the public interest and that the enormously wide discretion which it arrogates to itself is necessary if it is to function efficiently and effectively. Whilst not wishing to become involved in the political controversy on the relative merits of self-regulation and governmental or statutory regulation, I am content to assume for the purposes of this appeal that self-regulation is preferable in the public interest. But that said, what is to happen if the panel goes off the rails? Suppose, perish the thought, that it were to use its powers in a way which was manifestly unfair. What then? [Counsel for the Panel] submits that the panel would lose the support of public opinion in the financial markets and would be unable to continue to operate. Further or alternatively, Parliament could and would intervene. Maybe, but how long would that take and who in the meantime could or would come to the assistance of those who were being oppressed by such conduct?

.....

The Panel is a truly remarkable body, performing its function without visible means of legal support. But the operative word is 'visible,' although perhaps I should have used the word 'direct.' Invisible or indirect support there is in abundance. Not only is a breach of the code, so found by the Panel, ipso facto an act of misconduct by a member of the [London] Stock Exchange, and the same may be true of other bodies represented on the panel, but the admission of shares to the **Official List** may be withheld in the event of such a breach. This is interesting and significant for listing of securities is a statutory function performed by the Stock Exchange in pursuance of the Stock Exchange (Listing) Regulations 1984 (S.I. 1984 No. 716), enacted in implementation of EEC directives. And the matter does not stop there, because in December 1983 the Department of Trade and Industry made a statement explaining why the Licensed Dealers (Conduct of Business) Rules 1983 (S.I. 1983 No. 585) contained no detailed provisions about takeovers. It said:

'There are now no detailed provisions in these statutory rules about takeovers and the following paragraphs set out the provisions as regards public companies and private companies respectively. As regards public companies (as well as private companies which have had some kind of public involvement in the ten years before the bid) the Department considers it better to rely on the effectiveness and flexibility of the City Code on Takeovers and Mergers, which covers bids made for public companies and certain private companies which have had some past public involvement...'

The picture which emerges is clear. As an act of government it was decided that, in relation to takeovers, there should be a central self-regulatory body which would be supported and sustained by a periphery of statutory powers and penalties wherever non-statutory powers and penalties were insufficient or non-existent or where EEC requirements called for statutory provisions.

No one could have been in the least surprised if the Panel had been instituted and operated under the direct authority of statute law, since it operates wholly in the public domain. Its jurisdiction extends throughout the United Kingdom. Its Code and rulings apply equally to all who wish to make takeover bids or promote mergers, whether or not they are members of bodies represented on the Panel. Its lack of a direct statutory base is a complete anomaly, judged by the experience of other comparable markets world wide. The explanation is that it is an historical 'happenstance,' to borrow a happy term from across the Atlantic. Prior to the years leading up to the 'Big Bang,' the City of London prided itself upon being a village community, albeit of an unique kind, which could regulate itself by pressure of professional opinion...

The issue is thus whether the historic supervisory jurisdiction of the Queen's courts extends to such a body discharging such functions, including some which are quasi-judicial in their nature, as part of such a system. [Counsel] for the Panel, submits that it does not. He says that this jurisdiction only extends to bodies whose power is derived

from legislation or the exercise of the prerogative. [Counsel] for the applicants, submits that this is too narrow a view and that regard has to be had not only to the source of the body's power, but also to whether it operates as an integral part of a system which has a public law character, is supported by public law in that public law sanctions are applied if its edicts are ignored and performs what might be described as public law functions.

In *Reg. v. Criminal Injuries Compensation Board, Ex parte Lain* [1967] 2 Q.B. 864, 882, Lord Parker C.J., who had unrivalled experience of the prerogative remedies both on the Bench and at the Bar, said that the exact limits of the ancient remedy of certiorari had never been and ought not to be specifically defined. I respectfully agree and will not attempt such an exercise. He continued:

'They have varied from time to time being extended to meet changing conditions. At one time the writ only went to an inferior court. Later its ambit was extended to statutory tribunals determining a *lis inter partes*. Later again it extended to cases where there was no *lis* in the strict sense of the word but where immediate or subsequent rights of a citizen were affected. The only constant limits throughout were that it was performing a public duty. Private or domestic tribunals have always been outside the scope of certiorari since their authority is derived solely from contract, that is, from the agreement of the parties concerned... We have as it seems to me reached the position when the ambit of certiorari can be said to cover every case in which a body of persons of a public as opposed to a purely private or domestic character has to determine matters affecting subjects provided always that it has a duty to act judicially. Looked at in this way the board in my judgment comes fairly and squarely within the jurisdiction of this court. It is, as Mr. Bridge said, "a servant of the Crown charged by the Crown, by executive instruction, with the duty of distributing the bounty of the Crown." It is clearly, therefore, performing public duties.'

...

In fact, given its novelty, the Panel fits surprisingly well into the format which this court had in mind in the *Criminal Injuries Compensation Board* case. It is without doubt performing a public duty and an important one. This is clear from the expressed willingness of the Secretary of State for Trade and Industry to limit legislation in the field of takeovers and mergers and to use the Panel as the centrepiece of his regulation of that market. The rights of citizens are indirectly affected by its decisions, some, but by no means all of whom, may in a technical sense be said to have assented to this situation, e.g. the members of the Stock Exchange. At least in its determination of whether there has been a breach of the code, it has a duty to act judicially and it asserts that its *raison d'être* is to do equity between one shareholder and another. Its source of power is only partly based upon moral persuasion and the assent of institutions and their members, the bottom line being the statutory powers exercised by the Department of Trade and Industry and the Bank of England. In this context I should be very disappointed if the courts could not recognise the realities of executive power and allowed their vision to be clouded by the subtlety and sometimes complexity of the way in which it can be exerted.

Given that it is really unthinkable that, in the absence of legislation such as affects trade unions, the Panel should go on its way cocooned from the attention of the courts...

In reaching my conclusion that the court has jurisdiction to entertain applications for the judicial review of decisions of the panel, I have said nothing about the substantial arguments of [counsel for Panel] based upon the practical problems which are involved. These, in my judgment, go not to the existence of the jurisdiction, but to how it should be exercised and to that I now turn.

### ***The practical issue***

[Counsel for the Panel] waxed eloquent upon the disastrous consequences of the court having and exercising jurisdiction to review the decisions of the Panel and his submissions deserved, and have received, very serious consideration. In a skeleton argument, he put it this way:

‘Even if, which is not accepted, there is an apparent anomaly for an inability to challenge a patently wrong decision which may have important consequences, countervailing disadvantages would arise if the decisions were open to review. Applications would often be made which were unmeritorious. The fact that the court could dismiss such applications does not prevent their having a substantial effect in dislocating the operation of the market during the pendency of proceedings, in creating uncertainty in areas where it is vital that there should be finality. That finality should more appropriately exist at the threshold stage, by denying the possibility of action, rather than at the subsequent stage when the court comes to exercise its discretion since by that time there will already have been a lack of finality for a period. The nature of the rulings of the Takeover Panel are particularly required to have speed and certainty: they may be given in the middle of a bid, and they clearly may affect the operation of the market, and even short-term dislocation could be very harmful. The present case illustrates the uncertainty within the market which can be created by the mere bringing of an application. The issue is important for self-regulation as a whole. It would create uncertainty if it were to be said that each self-regulating body were to be considered in the context of the entire factual background of its operation, and of the peculiar features of the take-over panel which made it susceptible to judicial review. It would obviously have wide ranging consequences if there were general statements that self-regulating bodies carrying out important functions were susceptible to judicial review.’

I think that it is important that all who are concerned with takeover bids should have well in mind a very special feature of public law decisions, such as those of the Panel, namely that however wrong they may be, however lacking in jurisdiction they may be, they subsist and remain fully effective unless and until they are set aside by a court of competent jurisdiction. Furthermore, the court has an ultimate discretion whether to set them aside and may refuse to do so in the public interest, notwithstanding that it holds and declares the decision to have been made *ultra vires*: see, for example, *Reg. v. Monopolies and Mergers Commission, Ex parte Argyll Group Plc.* [1986] 1 WLR 763. That case also illustrates the awareness of the court of the special needs of the financial markets for speed on the part of decision-makers and for being able to rely upon those decisions as a sure basis for dealing in the market. It further illustrates an awareness that such decisions affect a very wide public which will not be parties to the dispute and that their interests have to be taken into account as much as those of the immediate disputants.

In the context of judicial review, it must also be remembered that it is not even possible to apply for relief until leave has been obtained. The purpose of this provision was explained by Lord Diplock in *Reg. v. Inland Revenue Commissioners, Ex parte National Federation of Self-Employed and Small Businesses Ltd.* [1982] A.C. 617, 642–643:

‘The need for leave to start proceedings for remedies in public law is not new. It applied previously to applications for prerogative orders, though not to civil actions for injunctions or declarations. Its purpose is to prevent the time of the court being wasted by busybodies with misguided or trivial complaints of administrative error, and to remove the uncertainty in which public officers and authorities might be left as to whether they could safely proceed with administrative action while proceedings for judicial review of it were actually pending even though misconceived.’

In many cases of judicial review where the time scale is far more extended than in the financial markets, the decision-maker who learns that someone is seeking leave to challenge his decision may well seek to preserve the status quo meanwhile and, in particular, may not seek to enforce his decision pending a consideration of the matter by the court. If leave is granted, the court has the necessary authority to make orders designed to achieve this result, but usually the decision-maker will give undertakings in lieu. All this is but good administrative practice. However, against the background of the time scales of the financial market, the courts would not expect the Panel or those who should comply with its decisions to act similarly. In that context the Panel and those affected should treat its decisions as valid and binding, unless and until they are set aside. Above all they should ignore any application for leave to apply of which they become aware, since to do otherwise would enable such applications to be used as a mere ploy in takeover battles which would be a serious abuse of the process of the court and could not be adequately penalised by awards of costs.

If this course is followed and the application for leave is refused, no harm will have been done. If the application is granted, it will be for the court to decide whether to make any and, if so, what orders to preserve the status quo. In doing so it will have regard to the likely outcome of the proceedings which will depend partly upon the facts as they appear from the information at that time available to the court, but also in part upon the public administrative purpose which the Panel is designed to serve. This is somewhat special.

Consistently with its character as the controlling body for the self-regulation of takeovers and mergers, the Panel combines the functions of legislator, court interpreting the Panel's legislation, consultant, and court investigating and imposing penalties in respect of alleged breaches of the code. As a legislator it sets out to lay down general principles, on the lines of EEC legislation, rather than specific prohibitions which those who are concerned in take-over bids and mergers can study with a view to detecting and exploiting loopholes.

Against that background, there is little scope for complaint that the Panel has promulgated rules which are ultra vires, provided only that they do not clearly violate the principle proclaimed by the Panel of being based upon the concept of doing equity between one shareholder and another. This is a somewhat unlikely eventuality.

When it comes to interpreting its own rules, it must clearly be given considerable latitude both because, as legislator, it could properly alter them at any time and because of the form which the rules take, i.e. laying down principles to be applied in spirit as much as in letter in specific situations. Where there might be a legitimate cause for complaint and for the intervention of the court would be if the interpretation were so far removed from the natural and ordinary meaning of the words of the rules that an ordinary user of the market could reasonably be misled. Even then it by no means follows that the court would think it appropriate to quash an interpretative decision of the panel. It might well take the view that a more appropriate course would be to declare the true meaning of the rule, leaving it to the Panel to promulgate a new rule accurately expressing its intentions.

Again the Panel has powers to grant dispensation from the operation of the rules: see, for example, Rule 9.1. of the code. This is a discretionary power only fettered by the overriding obligation to seek, if not necessarily to achieve, equity between one shareholder and another. Again I should be surprised if the exercise of this power could be attacked, save in wholly exceptional circumstances and, even then, the court might well take the view that the proper form of relief was declaratory rather than substantive.

This leaves only the Panel's disciplinary function. If it finds a breach of the rules proved, there is an internal right of appeal which, in accordance with established principles, must be exercised before, in any ordinary circumstances, the court would

consider intervening. In a case, such as the present, where the complaint is that the Panel should have found a breach of the rules, but did not do so, I would expect the court to be even more reluctant to move in the absence of any credible allegation of lack of bona fides. It is not for a court exercising a judicial review jurisdiction to substitute itself for the fact-finding tribunal and error of law in the form of finding of fact for which there was no evidence or in the form of a mis-construction of the panel's own rules would normally be a matter to be dealt with by a declaratory judgment. The only circumstances in which I would anticipate the use of the remedies of certiorari and mandamus would be in the event, which I hope is unthinkable, of the Panel acting in breach of the rules of natural justice – in other words, unfairly.<sup>64</sup>

Nothing that I have said can fetter or is intended to or should be construed as fettering the discretion of any court to which application is made for leave to apply for judicial review of a decision of the Panel or which, leave having been granted, is charged with the duty of considering such an application. Nevertheless, I wish to make it clear beyond peradventure that in the light of the special nature of the Panel, its functions, the market in which it is operating, the time scales which are inherent in that market and the need to safeguard the position of third parties, who may be numbered in thousands, all of whom are entitled to continue to trade upon an assumption of the validity of the Panel's rules and decisions, unless and until they are quashed by the court, I should expect the relationship between the Panel and the court to be historic rather than contemporaneous. I should expect the court to allow contemporary decisions to take their course, considering the complaint and intervening, if at all, later and in retrospect by declaratory orders which would enable the Panel not to repeat any error and would relieve individuals of the disciplinary consequences of any erroneous finding of breach of the rules. This would provide a workable and valuable partnership between the courts and the Panel in the public interest and would avoid all of the perils to which [counsel for the Panel] alluded.

The court in *Datafin* asserted its jurisdiction over the Takeover Panel. The court observed that although the Panel is, as it was at this time, a self-regulatory body, the state enables it to perform its role by explicitly deferring to its regulatory function and by providing it with indirect or 'invisible' support in carrying out its role. However, although it asserts its jurisdiction to judicially review the Panel, the Court of Appeal is extremely deferential to the Panel in two respects. First, it makes it clear that the likelihood of intervention is very low. For example, the court notes in relation to the interpretation of the Code that the Panel must be given 'considerable latitude'. In relation to a Panel decision to grant dispensation from the application of a rule the court notes that it will only intervene in 'exceptional circumstances'. Secondly, the court distinguishes between its assertion of power to judicially review the Panel's decisions and the nature of the review. The court accepted the submissions of the Panel's counsel that the mere possibility that the court could quash the Panel's decision would dislocate 'the operation of the market during the pendency of proceedings [by] creating uncertainty in areas where it is vital that there should be finality', and, accordingly, holds that the nature of the review should be 'historic rather than contemporaneous'. This means that the actual decisions that are the subject of the judicial review application will not be disturbed even by a negative holding. Such a holding will merely provide direction for the Panel's future

<sup>64</sup> For example, the courts would be willing to intervene and quash a Panel decision if in relation to a Panel member, or member of the Executive, involved in the ruling in question there is demonstrated to be a 'real danger of bias' on the part of such Panel or Executive member (*Panel on Takeovers and Mergers and Another [Hong Kong] v Cheng Kai-man* [1995] 4 LRC 369 (Privy Council)) citing Lord Goff in *R v Gough* [1993] AC 646 holding that the test was whether there was 'a real danger of bias on the part of the relevant member of the tribunal in question, in the sense that he might unfairly regard (or have unfairly regarded) with favour, or disfavour, the case of a party to the issue under consideration by him'.

decision-making and will have no bearing on the actual transaction from which the dispute arose. Although, of course, individuals who are subject to disciplinary sanctions arising from the Panel decision that is 'historically' quashed by the court will be relieved of those sanctions. Such a holding will merely provide direction for the Panel's future decision-making and will have no bearing on the actual transaction from which the dispute arose. The approach in *Datafin* enables the courts to assert jurisdiction while not interfering with the central benefits of takeover regulation through the Code and the Panel.

It is important to understand that the 'historic' approach set out in *Datafin* is underpinned by the policy concern that the judicial review process must not interfere with the need for quick and definitive decision making in a takeover bid. Where this policy concern is inapplicable so too is the 'historic approach'. There is, therefore, no blanket application of this principle to the Takeover Panel's decisions and activities. This is seen in the Court of Appeal's decision in *R v Panel on Takeovers and Mergers, ex p Guinness plc* decided shortly after *Datafin*.

***R v Panel on Takeovers and Mergers, ex p Guinness plc* [1989] 1 All ER 509**

[The headnote to the case sets out the facts as follows:]

In the course of a contested takeover by two public companies, Argyll and Guinness, for a third public company, Distillers, the purchase of a block of 3% of Distillers' shares by a Swiss company, Pipetec, was investigated by the Panel on Takeovers and Mergers at the request of Argyll. The Panel decided not to take the matter any further when it received an assurance from Guinness's finance director that Guinness and Pipetec were not acting in concert.<sup>65</sup> Guinness's bid for Distillers was successful but following the take-over the Department of Trade and Industry (the DTI) decided to investigate Guinness's affairs and the Panel decided to reopen its investigation into whether Pipetec had acted in concert with Guinness during the takeover of Distillers, contrary to the City Code on Takeovers and Mergers. The Panel subsequently advised Guinness that it would proceed to investigate the concert party issue without waiting for the outcome of the DTI inquiry, particularly since a copy of a letter purportedly from Pipetec to a director of Guinness had come to light, the contents of which, if correct, showed that Pipetec had acted in concert with Guinness. The Panel also advised Guinness that the two-stage investigation, which would not be disciplinary in nature, would (i) decide whether there had been a concert party and (ii) if so, consider the consequences. Guinness objected, seeking an adjournment of the hearing until the DTI inspectors' report had been published and any resulting criminal or civil proceedings concluded. The Panel nevertheless continued its inquiries and also received confirmation from the DTI of Pipetec's letter to Guinness. At a preliminary hearing of the Panel held to determine whether there should be an adjournment Guinness again sought an adjournment on the grounds (i) that the Panel's speedy and informal procedures, though appropriate in the context of a current bid, were ill-adapted to an inquiry after a takeover, which was to be equated with disciplinary proceedings, and (ii) that essential witnesses from Switzerland regarding Pipetec's letter to Guinness should be called for examination. The Panel refused the adjournment and further refused to vacate the date for the hearing of the concert party issue, because of its concern for the former shareholders in Distillers to whom Guinness would be liable for any breach of the code, and because of the fact that the Panel had received no information from Guinness which cast doubt on the strong evidence in favour of a concert party. Immediately before the hearing of the concert party issue the Panel Executive delivered to Guinness the final version of its submissions to the Panel, which contained a new and significant addition, namely a letter from the solicitors of Pipetec's Swiss bank amounting to an admission that Pipetec's purchase of shares in

<sup>65</sup> On the meaning of 'acting in concert' see Web Chapter A pp 96 - 97.



Distillers had been a concert party operation. At that hearing Guinness again sought an adjournment to enable it to respond to the Executive's final submissions but that was refused by the Panel. Without exercising its right of appeal to the Panel's Appeal Committee, Guinness then applied for judicial review of the Panel's decisions refusing adjournments. The Divisional Court dismissed the application and Guinness appealed to the Court of Appeal.

### **Lord Woolf MR**

I would also dismiss this appeal. I have, however, reservations as to the appropriateness of the actions of the Panel on Takeovers and Mergers and in these circumstances I feel I should set out my own reasons for coming to the same conclusion as the other members of the court...

I regard the unique qualities of the Panel as being important in deciding what is the correct outcome of this appeal. I have in mind two particular features of the Panel. The first is that its authority is not derived from any statutory power. Instead it derives its authority from the institutions in the City of London who give it their support and nominate its members. The second is that the scope of its activities are self-determined. Except in so far as the Panel itself decides to limit its jurisdiction and to set out its functions, as it has in the City Code on Takeovers and Mergers, the constraints on its powers are those dictated not by legal but by practical considerations...

These qualities of the Panel create constraints as to the circumstances and as to the manner in which the courts can intervene which do not exist in the case of statutory bodies. For example, in this case with some justification, it is suggested that the Panel, having decided to adopt an inquisitorial role in conducting its investigations as to whether or not Guinness plc had contravened the Code, could have pressed home those investigations more vigorously than it did. However, subject to what I have to say hereafter, the Panel is under no duty to carry out its investigations in any particular way and it must be for the Panel to decide to what extent it is appropriate for it having regard to its resources to engage in extensive investigations. Again in the case of a statutory body it is possible to identify considerations which it is under a statutory obligation to take into account or to ignore. Failure to comply with this statutory obligation can invalidate a decision. However, there is no equivalent obligation in the case of the panel.

The Panel's ability to carry on its activities without being subject to legal constraint or the intervention of the courts can however be limited by the nature of an activity which it undertakes. If in the private law sphere an individual, as a volunteer, undertakes to provide services which require professional standards of care, by undertaking those activities the individual becomes under an obligation, enforceable in law, to exercise the appropriate standard of care. So in the public law field, if the Panel, without being under any enforceable duty to do so, engages on an activity which can have consequences to a third party, then the Panel by so doing can impose on itself legally enforceable obligations of a similar nature to those to which it would be subject if it were carrying out that activity pursuant to a statutory duty. However, this does not mean the obligations are identical to those which would exist if it were under a statutory duty. In the normal case a body such as the Panel will retain a very wide discretion how it performs the task it sets itself and the court will regard its role as being one of last resort reserved for plain and obvious cases.

In this case the function on which the Panel embarked was to determine whether in the circumstances Guinness had contravened the terms of its own Code. Having set itself this adjudicative objective, the Panel placed itself under an obligation not to carry out this function in a manner which was inconsistent with that objective. If it reached a result which was unjust, this would be in breach of this obligation. In the words of its

then own chief executive, the Director General, Mr John Walker-Haworth, the object of the Panel's procedures is to produce the right answer in code terms in the circumstances. If it goes about this role in a manner which manifestly creates a real and not theoretical risk of injustice, then it would be abusing its power and, because it is performing a public function, on an application for judicial review the courts could intervene on behalf of the public to protect those liable to be adversely affected by the exercise of the power.

On the application for judicial review it is appropriate for the court to focus on the activities of the Panel as a whole and ask with regard to those activities, in the words of Lord Donaldson MR, 'whether something has gone wrong' in nature and degree which requires the intervention of the courts. Nowadays it is more common to test decisions of the sort reached by the panel in this case by a standard of what is called 'fairness'. I venture to suggest that in the present circumstances in answering the question which Lord Donaldson MR has posed it is more appropriate to use the term which has fallen from favour of 'natural justice'. In particular in considering whether something has gone wrong the court is concerned whether what has happened has resulted in real injustice. If it has, then the court has to intervene, since the Panel is not entitled to confer on itself the power to inflict injustice on those who operate in the market which it supervises.

On the facts of this appeal we are principally concerned with three decisions of the panel. They are: (1) the decision of 25 August 1987 to refuse an adjournment (the long-term adjournment decision); (2) the decision of 2 September 1987 not to adjourn (the short-term adjournment decision); and (3) the decision of the Panel on 2 September 1987 to reach its decision that Guinness had acted in breach of the code on the material then before the Panel and not to require further investigations to be carried out before it came to its determination (the inadequate investigation issue).

It is convenient to consider separately Guinness's case on each of these decisions. However, the outcome of Guinness's appeal does not necessarily depend on the result of that separate consideration, since, although intervention by the court may not be justified on an examination of any single decision, the intervention could be justified by the collective findings on the three decisions...

### ***The inadequate investigation issue***

In these circumstances it was desirable that the Panel should conduct a full investigation within the limits of its resources. In carrying out that investigation, unlike the situation on a normal investigation, the Panel was not under any pressing constraints as to time. Because of the delay which had already occurred, any reasonable period of extra time which the Panel needed to complete its inquiries would not materially affect the Distillers shareholders, whose interests the Panel was most anxious to protect.

Having carefully considered the documents which are now available but which were not available to Guinness until discovery in these proceedings, it is my impression that, whether or not there was any legal obligation to do so, it would have been preferable for the Panel to carry out fuller inquiries than it did. Its failure to do so is probably explained by a natural tendency to conduct this investigation in the same way as investigations are normally conducted in the heat of a takeover battle, the fact that the date for the hearing had been provisionally arranged for 2 September and the fact that the executive regarded itself as already in possession of evidence which indicated a virtually irrefutable case against Guinness...

[Following a detailed consideration of the facts Lord Woolf MR concluded that 'while the Panel... could have been more energetic, this did not affect the outcome and the court would not be justified in intervening on this ground.']

### ***The short adjournment decision***

I regret that the Panel did not feel able to accede to the submission that the hearing should be adjourned for a few weeks. Such an adjournment could not possibly have caused prejudice to anyone, but it would clearly have caused inconvenience to the Panel and difficulty in finding another date when the Panel could reassemble... However, while making this criticism of the Panel's decision, I wholly agree with the view expressed by Watkins LJ in the Divisional Court that this amounted to no more than inconsideration on the part of the Panel. Events since 2 September have clearly shown, as the Panel was entitled to assume would be the position, that a limited period adjournment would not have enabled additional material to have been obtained by Guinness: it would merely have provided an opportunity to Guinness to reflect on the manner in which they would present their case, and could not in any way have affected the final outcome.

### ***The long adjournment***

[After detailed consideration of the facts Lord Woolf concluded that he could 'not fault' the Panel.]

It remains for me to consider whether, looking at the cumulative effect of the argument so ably advanced by counsel for Guinness, I consider this is a case in which the court is required to intervene, adopting the approach which I identified at the beginning of this judgment. The conclusion which I have come to, while in agreement with Lloyd LJ that many of the criticisms counsel makes of the Panel's conduct are well founded, is that the intervention would not be justified because no injustice has been caused and what was wrong was not of the nature or gravity which required the intervention of the court. The decisions were after all in the field of activities which the Panel's combined experience and expertise make it peculiarly well qualified to determine and in this field as a matter of substance and discretion the court should only interfere to avoid injustice. Although I have come to this conclusion, I acknowledge, as I did earlier, that the appeal none the less has caused me concern. I trust with hindsight the panel will understand the reasons for this concern and that this will enable the Panel to avoid situations arising in the future where a body, the subject of its decision, can feel a genuine sense of grievance because of the way in which an inquiry has been conducted. In making this last comment I do, however, stress that I do not intend to deter the Panel from acting with all due expedition where this is required. Here the situation was different from normal and this case gave the Panel scope to be more accommodating in the interests of Guinness than would usually be possible. In these circumstances to rush the investigation so as to obtain an early hearing while not unlawful was insensitive.

Lord Woolf's judgment is very critical of the Panel's procedures and approach to the case. He makes several specific criticisms of the decisions it made. However, ultimately he concludes that no injustice was in fact done to Guinness and, therefore, that there was no need for any intervention by the court. While critical of the Panel the court remains deferential to it. Lord Woolf puts into effect his observation that 'the court will regard its role as being one of last resort reserved for plain and obvious cases'. Nevertheless, while not intervening, the court through its explicit criticisms clearly provides guidance for the Panel in relation to the future conduct of such inquiries. Importantly, however, this is not an example of 'historic' as opposed to 'contemporaneous' judicial review as articulated in the *Datafin* case. The court here applies contemporaneous review: had it determined that the Panel's actions justified intervention the court's finding would have been directly applicable to this case. Historic review would involve action by the Panel that *justified* and resulted in an intervention, however, the intervention would only have an impact on the Panel's future behaviour – the way in which it could act in the future, for example, by preventing the making of a particular ruling, or the adoption of certain procedures. Guinness confirms that the *historic review* approach is only applicable when the policy drivers which underpin it – the need for quick and definitive decision making – are present, which will typically be, in Lord Woolf's words, in the 'heat of a takeover battle'. Outside of that context the courts may intervene contemporaneously in relation to the

Takeover Panel's action in the actual case.<sup>66</sup> This approach means, of course, that parties are unlikely to attempt to judicially review the Panel's decision 'in the heat of a takeover battle' as even if they are successful they will not themselves benefit from the court's ruling, unless they are repeat players who are looking to benefit from a ruling in a separate, future transaction.

*Guinness* also reaffirms that the nature and function of the Panel affect not only the application of the intervention – historic versus contemporaneous – but also the court's willingness to intervene at all. A question of importance in this regard is whether placing the Takeover Panel on a statutory footing will result in a less deferential stance by the courts, whether or not the intervention is historic or contemporaneous. Tunde Ogowewo has argued that this is possible if one gives due weight to the factors identified by the courts to justify the deferential stance.<sup>67</sup> Lord Woolf refers in his judgment to three factors: the absence of statutory authority; the fact that the scope of the Panel's activities are self-determined; and the 'combined experience and expertise' of the Panel. As a result of the implementation of the EU's Directive on Takeovers the Takeover Panel now has statutory authority and, although the Companies Act 2006 provides very broad authority to the Panel, as we have seen the scope of its activities are not completely self-determined. Its combined experience and expertise, however, remains unaltered. Accordingly, one of the three bases of deference is removed and another qualified. It remains to be seen whether this will result in a greater willingness of the courts to intervene. One suspects that the third pillar of deference – experience and expertise – will result in the judicial review status quo remaining unaltered.

## 4 *The Panel's enforcement powers*

Section 952 of 2006 Act empowers the Panel to impose sanctions for breach of the Code. These sanctions are set forth in the introduction to the Code.<sup>68</sup> Of course one of the remarkable features of the pre-Takeover Directive Takeover Panel was its ability to enforce compliance without recourse to state authority. As we shall see below, the Panel's self-regulatory sanctions continue, in somewhat modified form, to be the primary, enforcement tools.

The Panel's original self-regulatory sanction for market participants that failed to comply with the Code or cooperate with the Panel's rulings was the ability of the Panel to prevent such participants from functioning in the market for corporate control by requiring that other market players 'cold-shoulder' them. The bodies and trade associations that formed the Panel would, acting on the Panel's 'cold-shoulder' instruction, ensure that their members did not act for or deal with the delinquent person.

Today 'cold-shouldering' still remains an important Panel sanction although it is no longer a purely market-generated sanction. The Market Conduct Rules (MCR) of the Financial Services Authority's Handbook now provide that:

A firm must not act, or continue to act, for any person in connection with a transaction to which the Takeover Code applies... if the firm has reasonable grounds for believing that the person in question, or his principal, is not complying or is not likely to comply with the Takeover Code.<sup>69</sup>

<sup>66</sup> Note that this could include review of the Panel's decision to require a shareholder or group of shareholders to make a mandatory bid pursuant to Rule 9 of the Code. See further, section III below.

<sup>67</sup> See further in this regard T. Ogowewo, 'Tactical Litigation in Takeover Contexts' (2007) *Journal of Business Law* 589, 614–8.

<sup>68</sup> Takeover Code, Introduction, para 11(b).

<sup>69</sup> FSA Market Conduct Rule 4.3 *Support of the Takeover Panel's Functions*.

The 'firm' referred to in this section is a person authorized by the Financial Services Authority to carry out 'regulated activities' (an 'authorised person'). Regulated activities include an extremely broad range of financial activities including: advising on investments; running an investment fund; dealing in investments as agent; and taking deposits.<sup>70</sup> Rule 4.3.2 of the MCR clarifies that if the Panel has made a statement that a person cannot be expected to comply with the Code then 'firms' should not act for the identified person. Such a statement from the Takeover Panel will be made by the Hearings Committee following referral by the Executive in relation to an alleged breach of the Code.<sup>71</sup> The effect of the statement is, therefore, that 'authorised persons' including, for example, brokers and investment bankers, will not be able to work for the person named in the statement whenever such person wishes to engage in takeover activity.<sup>72</sup> Any authorized person that does work with such a named person will be in breach of the MCR, which could lead to enforcement action by the FSA and the imposition of sanctions on that authorized person – including the revocation of any authorization to carry out the regulated activity.<sup>73</sup>

In addition to cold-shouldering the Code now also empowers the Panel to make *compensation rulings* in relation to a specified set of Code rules<sup>74</sup> – including in particular rules on the amount and form of consideration<sup>75</sup> as well as the mandatory bid rule<sup>76</sup> – which would require the bidder to compensate the target company's shareholders. So, for example, where the bidder is in breach of the pricing rules (which we consider in detail below) because during the course of the offer he paid one shareholder more than the others for the shares,<sup>77</sup> the Panel may direct him to pay the higher amount to all the other shareholders who accepted the offer. This enforcement power is a new power resulting from placing the Takeover Panel on a statutory footing.<sup>78</sup>

The Panel also has the option of reporting the delinquent person in question to the apposite domestic or overseas regulatory body, such as the FSA, or any applicable professional body,

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<sup>70</sup> A list of Regulated Activities is set out in Schedule II of the FSMA 2000.

<sup>71</sup> Takeover Code, Introduction, Section 11(b)(v).

<sup>72</sup> Firms are not prevented in carrying out other – non-takeover – related activity, MAR 4.3.3(2).

<sup>73</sup> Section 54 FSMA 2000.

<sup>74</sup> Takeover Code, Introduction, section 10(2). The Takeover Code Rules in relation to which compensation rulings may be imposed are rules: 6, 9, 11, 14, 15, 16 and 35.3.

<sup>75</sup> See Web Chapter A, B.II.4.

<sup>76</sup> See Web Chapter A, B.III.

<sup>77</sup> See Web Chapter A, B.II.

<sup>78</sup> The statutory authority for the Panel to impose compensation rulings is provided by section 954 Companies Act 2006.

who may elect to take enforcement or disciplinary action.<sup>79</sup> Following referral to the FSA, for example, the FSA could impose financial penalties<sup>80</sup> or even delist the company in question.<sup>81</sup> The new compensation sanction and the referral sanction are important where the 'cold-shoulder' statement is not expected to be an effective deterrent. The cold-shoulder sanction will only be effective if the person in question would wish to be involved in takeover activity in the future. If the delinquent market player has no intention of engaging in future takeover activity then alternative sanctions are necessary to deter them from breaching the Code.

The Panel also has available to it the less draconian sanctions of private censure and public censure. Indeed, in practice enforcement action will typically involve one of these two sanctions together, where appropriate, with agreed upon action by the delinquent party.<sup>82</sup> The Panel explicitly prefers consensual enforcement action solutions. In its consultation document on the implementation of the EU's Takeover Directive it observed that:

The Panel continues to believe that the consensual approach to enforcement of the Code and its rulings is the most effective way of securing the appropriate remedy or compensation and that such consensus should continue to be achievable through the application of the Panel's processes for making, reviewing and appealing decisions.<sup>83</sup>

With regard to the procedure for the imposition of sanctions by the Panel, the Executive is empowered to deal with the disciplinary matter 'where the person who is to be subject to the disciplinary action agrees the facts and the action proposed by the Executive'.<sup>84</sup> Otherwise the disciplinary matter will be addressed by the Hearings Committee following referral by the Executive.

The above sanctions are disciplinary sanctions whose primary function is to deter market participants from breaching the Code as well as compensating persons who have been damaged as a result of such breaches. However, in addition to these disciplinary sanctions the Code, supported by the Companies Act 2006, provides for other enforcement mechanisms to ensure immediate compliance with the Code. Most importantly in this regard are the *Compliance Rulings*.<sup>85</sup> Where the Panel is satisfied that a person has contravened the

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<sup>79</sup> Takeover Code, Introduction, Section 11(b).

<sup>80</sup> See section 66 Financial Markets and Services Act (FSMA) and the FSA's Decision Procedures and Penalties Manual.

<sup>81</sup> Section 77 FSMA 2000.

<sup>82</sup> In 2007 the only enforcement action taken was public censure of Monterrey Investment Management Limited (Takeover Panel Statement 2007/29) and N M Rothschilds & Sons Ltd (Takeover Panel Statement 2007/06) and in 2008 there was no enforcement action (available at <http://www.thetakeoverpanel.org.uk/statements/panel-statements>).

<sup>83</sup> *The Panel on Takeovers and Mergers: Consultation Paper – The Implementation of the Takeovers Directive; Proposals relating to amendments to be made to the Takeover Code* (2005), para 10.8.3.

<sup>84</sup> Takeover Code, Introduction, Section 11(a). For a recent *public censure* by the Panel Executive see the Panel Executives 'statement of criticism' of Monterrey Investment Management Limited for 'failing to disclose dealings in relevant securities of iSOFT and IBA' (The Takeover Panel 2007/29).

<sup>85</sup> Takeover Code, Introduction, Section 10(b).

Code, or there is a reasonable likelihood that there will be a contravention, the Panel can make a direction restraining the applicable person from acting in contravention of the Code. The Companies Act 2006 now places the power of the courts directly behind Code and the rulings of the Panel. If necessary, the Panel may, pursuant to section 955 of the Companies Act 2006, apply to court and where a person has contravened the Code or is reasonably likely to contravene the Code,<sup>86</sup> the court is empowered to make any order it thinks fit in order to ensure compliance with the Code.

The Act also facilitates the enforcement of the Code by enhancing the Panel's powers to determine whether enforcement action is necessary. It does this by empowering the Panel to require persons to produce documents and information requested by the Panel which are 'reasonably required' by the Panel in connection with the performance of its functions.<sup>87</sup> The court-enforcement power applies also to any non-contravention of disclosure request.<sup>88</sup>

Two final points with regard to enforcement of the Code should be noted. First, only the Panel can take the action set out above to enforce the Code. Section 956(1) of the Companies Act 2006 provides that breach of the Code does not amount to a breach of statutory duty. Accordingly, no party to a takeover who believes another party is in breach of the Code may bring a court action to enforce compliance. Such party's only recourse is to the Takeover Panel and the Appeal Board itself. Second, if a transaction is completed even though some of the relevant parties have been or are later discovered to have been in breach of the Code, while this could lead to a *compensation ruling*, disciplinary action by the Panel or enforcement action by the FSA, such sanctions or action *does not* affect the validity and enforceability of the takeover transaction.<sup>89</sup>

#### Questions:

1. What are the pros and the cons of self-regulation?
2. In what respects, if any, does placing the Takeover Panel on a statutory footing threaten the purported benefits of self-regulation of the market for corporate control?
3. How does historic approach to judicial review operate?
4. What are the policy rationales for historic approach to judicial review and to what, if any, extent are such rationales affected by the status of the Takeover Panel as the designated supervisory authority?

## II Regulating the takeover process

### 1 *The structure and application of the Takeover Code*

#### 1.1 Principles, rules and notes

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<sup>86</sup> Section 955(4) CA 2006 makes it clear that this section can be used to enforce the rules and a requirement 'imposed by or under the rules', which would include a ruling made by the Panel.

<sup>87</sup> Section 947 CA 2006.

<sup>88</sup> Section 955(1) and (4) CA 2006.

<sup>89</sup> Section 956(2) Companies Act 2006.

The forerunner to the Takeover Code, *The Notes on the Amalgamation of Business*, consisted of several unnumbered provisions taking up eight pages. Today the Takeover Code is set out in a document that, at the time of writing, consists of 285 pages. The primary Code document, which takes up a limited number of these pages, consists of six General Principles, 38 Rules and seven appendices. In addition to the rules, the Code provides detailed commentary on the meaning of each of the Rules in its *Notes on the Rules* set out after each rule, which provide both clarity on the meaning of the primary rules but also, in effect, provide sub-rules applicable to a takeover offer.

Whilst the Code is made up of a considerable number of highly specific rules its self-conception is that it is a form of principles-based regulation. In this context this means that the rules and the sub-rules must be understood and applied in accordance with the underlying principles and spirit of the Code. Principles-based regulation contrasts with rules-based regulation where the rules are applied without a requirement to have regard to the underlying principle of the rule/the spirit of the rule. For proponents of principles-based regulation, the problem with rules-based regulation is that it can lead to over-inclusiveness where a rule applies in situations where, had there been regard to the principle which the rule instantiates, it would not have applied, or under-inclusiveness where the rule does not apply to and fails to regulate activity that clearly falls within the concern of the underlying principle.<sup>90</sup> In this regard the Code makes the following introductory observations:

The Code is based upon a number of General Principles, which are essentially statements of standards of commercial behaviour. These General Principles are the same as the general principles set out in Article 3 of the Directive. They apply to takeovers and other matters to which the Code applies. They are expressed in broad general terms and the Code does not define the precise extent of, or the limitations on, their application. They are applied in accordance with their spirit in order to achieve their underlying purpose. In addition to the General Principles, the Code contains a series of rules. Although most of the rules are expressed in less general terms than the General Principles, they are not framed in technical language and, like the General Principles, are to be interpreted to achieve their underlying purpose. Therefore, their spirit must be observed as well as their letter.

The Code is, therefore, 'based upon' the six General Principles. These principles are the primary objectives that the more specific rules implement and the rules, therefore, must be interpreted and understood in light of these principles. However, note that beyond saying that the Code is 'based upon' the general principles it does not directly say that the rules must be interpreted in light of these principles. While this paragraph does provide that the rules must 'be interpreted to achieve their underlying purpose' and that 'their spirit must be observed as well as their letter', it does not equate such 'underlying purpose' with those General Principles. That is, there are more principles and more spirit than simply the general principles themselves.

Whilst the Code professes to be 'based upon' the General Principles, in fact the current Principles set out in the Code resulted from amendments to the Code required to implement the EU's Takeover Directive.<sup>91</sup> Article 3 of the Directive provides a list of the principles that the Member States must ensure are complied with. These principles (the 'New General Principles') are transposed verbatim into the Code's general principles replacing the Code's original 'general principles' (the 'Old General Principles'). Prior to the adoption of the Directive's six principles the Takeover Code had 10 General Principles. As we shall see

<sup>90</sup> See Chapter 9, pp 288–9. See generally F. Schauer, *Playing By The Rules: A Philosophical Examination of Rule Based Decision Making In Law and Life* (Clarendon Press, 1991); J. Black, *Rules and Regulators* (OUP, 1997); D. Kershaw, 'Evading Enron: Taking Principles Too Seriously in Accounting Regulation' (2005) 68 *Modern Law Review* 594–625.

<sup>91</sup> Directive 2004/25/EC of the European Parliament and of the Council on takeover bids.



below there is considerable congruence between the original Code principles and the Directive's principles. Indeed, the Directive's principles clearly draw upon the Code's original General Principles. However, in several respects in terms of coverage and emphasis they are different. The Panel gave detailed consideration to the issue of how to adopt the Directive's principles. It observed that the two sets of principles were very similar although acknowledged certain differences. It concluded that the appropriate approach was to adopt the Directive's Principles in whole and move any existing General Principle that was not covered in the Directive's Principles into the rules.<sup>92</sup> It also observed that to the extent that any original General Principle that was 'inconsistent [with] or less powerful' than the Directive's Principle, the latter would have to be followed.<sup>93</sup>

From a lawyer's perspective, therefore, the Code's assertion that the Code is 'based upon' the New General Principles is a very strange claim: the legal equivalent of growing a tree, transplanting that tree's roots with a tree of a similar but not identical variety and then asserting that the tree was the product of the new roots. Accordingly, before we analyse the current General Principles, it is well worth considering the Code's pre-Directive Principles, which one could argue are the real principles upon which the detailed Code rules are 'based'.

## **Pre-2005 City Code on Takeovers and Mergers**

### **General Principles**

1. All shareholders of the same class of an offeree company must be treated similarly by an offeror.
2. During the course of an offer, or when an offer is in contemplation, neither an offeror, nor the offeree company, nor any of their respective advisers may furnish information to some shareholders which is not made available to all shareholders. This principle does not apply to the furnishing of information in confidence by the offeree company to a bona fide potential offeror or vice versa.
3. An offeror should only announce an offer after the most careful and responsible consideration. Such an announcement should be made only when the offeror has every reason to believe that it can and will continue to be able to implement the offer: responsibility in this connection also rests on the financial adviser to the offeror.
4. Shareholders must be given sufficient information and advice to enable them to reach a properly informed decision and must have sufficient time to do so. No relevant information should be withheld from them.
5. Any document or advertisement addressed to shareholders containing information or advice from an offeror or the board of the offeree company or their respective advisers must, as is the case with a prospectus, be prepared with the highest standards of care and accuracy.
6. All parties to an offer must use every endeavour to prevent the creation of a false market in the securities of an offeror or the offeree company. Parties involved in offers must take care that statements are not made which may mislead shareholders or the market.
7. At no time after a bona fide offer has been communicated to the board of the offeree company, or after the board of the offeree company has reason to believe that a bona fide offer might be imminent, may any action be taken by the board of the offeree company in relation to the affairs of the company, without the

<sup>92</sup> *Takeover Panel*, 'The European Directive on Takeover Bids' (2005/10) 18, para (i). For example, what was Principle 7 is now set out in Rule 21, although is also partially covered by the new General Principle 3.

<sup>93</sup> *Takeover Panel*, 'The European Directive on Takeover Bids' (2005/10) 18, para (ii).

- approval of the shareholders in general meeting, which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits.
8. Rights of control must be exercised in good faith and the oppression of a minority is wholly unacceptable.
  9. Directors of an offeror and the offeree company must always, in advising their shareholders, act only in their capacity as directors and not have regard to their personal or family shareholdings or to their personal relationships with the companies. It is the shareholders' interests taken as a whole, together with those of employees and creditors, which should be considered when the directors are giving advice to shareholders. Directors of the offeree company should give careful consideration before they enter into any commitment with an offeror (or anyone else) which would restrict their freedom to advise their shareholders in the future. Such commitments may give rise to conflicts of interest or result in a breach of the directors' fiduciary duties.
  10. Where control of a company is acquired by a person, or persons acting in concert, a general offer to all other shareholders is normally required; a similar obligation may arise if control is consolidated. Where an acquisition is contemplated as a result of which a person may incur such an obligation, he must, before making the acquisition, ensure that he can and will continue to be able to implement such an offer.

In the contemporary Code the General Principles, in conformity with Article 3 of the Takeover Directive, provide as follows:

## **Takeover Code**

### **General Principles**

1. All holders of the securities of an offeree company of the same class must be afforded equivalent treatment; moreover, if a person acquires control of a company, the other holders of securities must be protected.
2. The holders of the securities of an offeree company must have sufficient time and information to enable them to reach a properly informed decision on the bid; where it advises the holders of securities, the board of the offeree company must give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company's places of business.
3. The board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid.
4. False markets must not be created in the securities of the offeree company, of the offeror company or of any other company concerned by the bid in such a way that the rise or fall of the prices of the securities becomes artificial and the normal functioning of the markets is distorted.
5. An offeror must announce a bid only after ensuring that he/she can fulfil in full any cash consideration, if such is offered, and after taking all reasonable measures to secure the implementation of any other type of consideration.
6. An offeree company must not be hindered in the conduct of its affairs for longer than is reasonable by a bid for its securities.

These six General Principles can be grouped into three categories: first, shareholder protection, and to a lesser extent non-shareholder constituency protection; second, financial market protection; and third, target company protection.

In the shareholder protection category the principles protect shareholders in three respects: (i) from the bidder *during the process* of the bid by the 'equivalent treatment' (Principle 1) and 'sufficient time and information' (Principle 2) requirements; (ii) from a bidder *as new controller*

*following the successful completion of the bid* who could, theoretically, following the acquisition of control act in ways that adversely affect the minority shareholders (Principle 1); and (iii) from the target company's board, by preventing it from acting in ways that could deny the shareholders the opportunity to decide on the merits of the bid (Principle 3).

Non-shareholder constituencies are protected by requiring the board, in a decidedly specific instruction for a 'general principle', to give its views on the employment effects of the takeover, and *arguably* (see below) by requiring the board to 'act in the interests of the company as a whole' (Principle 3).

Financial markets are protected through the Code in two respects: first, through the prohibition on the creation of false markets, meaning the sales and purchases in the shares of the target company that artificially distort the price of the shares (Principle 4); and, secondly, indirectly, by ensuring that only serious offerors come to market by requiring that the offeror ensures that it has any relevant cash consideration and has taken all reasonable steps to ensure the availability of alternative consideration (Principle 5).

The target company itself is the protected constituency of Principles 5 and 6. These principles recognize that takeover bids disrupt business activity and distract management and employees from doing their job. Bid activity and bidder behaviour may, therefore, be regulated in order to limit the interruption to the target company's normal business activity. This is the explicit objective of Principle 6 but Principle 5 also provides assistance in this regard by ensuring that the company is not distracted by unserious bidders who may not have the funding or other forms of consideration to complete an announced bid.

The differences between the New General Principles and the Old General Principles are both explicit and subtle. The new principles are briefer and, on the whole, less extensive. There is no corresponding new principle to Old Principle 5 and although Old Principles 8 and 10 are arguably covered by the second part of New Principle 1, requiring that other holders of securities 'must be protected' following a change of control, the coverage is more abstract and de-emphasized. Similarly, the strong and more specific Old Principle 7, providing that the board cannot frustrate an offer or deny the shareholders an opportunity to decide on the bid is de-emphasized, and narrowed by New Principle 3, which places it alongside the board's obligation to act in the interests of the company as a whole and refers only to denying 'the holders of securities an opportunity to decide on the merits of the bid'. In one respect the New Principles are broader than the Old Principles: whilst, as we shall see below, ensuring that the bid process does not excessively interfere with a target company's business has long been a clear objective of the Code, the Original General Principles did not explicitly provide an equivalent to New Principle 6.

Although one can argue that the differences between the new and the old principles are marginal, when one considers them within the context of the Directive as a whole, they are, it is submitted, more significant. And while literally they may provide a good enough fit with the Old Principles on which the Code was based, in several respects they are the product of the attempt to reach agreement among EU jurisdictions many of whom hold views on takeover regulation that are inconsistent with core aspects of the Code.<sup>94</sup> We see this most clearly in relation to the second part of New Principle 3 and Old Principle 7. The Takeover Directive provides in Article 9(2) for a non-frustration or neutrality principle preventing target company boards from acting in ways that prevent the shareholders from deciding on the merits of the bid. However, the Directive makes this rule optional for each Member State<sup>95</sup> and, in addition,

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<sup>94</sup> The conflict between member states in negotiating the Takeover Directive has been described as involving a clash of capitalisms: see H. Callaghan and M. Höpner, 'European Integration and the Clash of Capitalisms: Political Cleavages of Takeover Liberalization' (2005) *Comparative European Politics* 307; B. Clift, 'Second Time as Farce? The EU Takeover Directive, the Clash of Capitalism and the Hamstrung Harmonisation of European (and French) Corporate Governance' (2009) 47 *Journal of Common Market Studies* 56.

<sup>95</sup> *Ibid*, Article 12(2).

allows Member States who adopt it to make its application dependent on reciprocity<sup>96</sup> – that is, the application of the rule to the target company is dependent on whether the bidder company would also be subject to the neutrality rule if it was the object of a bid. Therefore, in certain EU jurisdictions, for example, Germany that has opted-out of Article 9(2), companies can, to the extent consistent with German company law, take action that denies the shareholders the opportunity to decide on the merits of the bid.<sup>97</sup> We will consider such defences in IV below. The point to note here is that the Directive from which the New General Principles are taken does not view the Principle of target board neutrality as inviolable as the Takeover Code and its Old General Principles do. One could argue further in this regard that the new emphasis in New Principle 6 on ensuring that the company is not hindered in the conduct of its affairs could be read as an implicit demotion for the neutrality principle. As we shall see below, enabling the company to carry out its business without interference is one of the arguments put forward in favour of allowing the target board to defend the company from an unwanted takeover bid. The elevation of this Principle represents a different emphasis than is found in the Old General Principles.

However, although as argued above there is a degree of disconnect between the New General Principles and the Old General Principles on which the Rules are in fact largely based, in practice this is unlikely to be of any significant consequence given the very general phrasing of the new principles and the fact that the body charged with interpreting the principles and implementing and enforcing the rules is the same body which drafted and enforced the original Code.

## 1.2 The Code, legal method and its relationship to company law

As we have seen, the rules and effective sub-rules found in the notes to the rules must be interpreted purposively in accordance with the underlying spirit of the rules.<sup>98</sup> This involves situating the literal meaning or meanings of the rule in relation to the Code's general principles but also to the underlying objective or purpose (the spirit) of the specific rules.

For companies and their advisors, where the meaning of a Code rule is unclear, guidance can be obtained from several sources: the non-binding Panel Executive's Practice Statements and the prior rulings of the Executive, the Hearings Committee and the Appeals Board. Having had regard to this guidance, if the matter is still unclear the Executive is available for direct consultation and, if requested, will provide a binding specific ruling (subject to appeal). Such a process of interaction between the regulator and repeat players (financial advisors and lawyers) has been described by Professor Julia Black as a 'regulatory conversation'<sup>99</sup> whereby the regulator and the regulated (or more accurately the regulated advisors) through repeat interaction and communication generate shared context which anchors what to outsiders would be unclear words, rules and principles, producing shared and clear meanings

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<sup>96</sup> *Ibid*, Article 12(3).

<sup>97</sup> Regarding the implementation of the bid and the countries that have opted out of the neutrality rule see the European Commission's *Report of the implementation of the Directive of Takeover Bids* (Commission Staff Working Document, 2007).

<sup>98</sup> In *R v Spens* [1991] 1 WLR 624 in a criminal case when considering whether the interpretation of the Code was a matter for the judge or the jury, Watkins LJ held that 'as to the present case, our view is that the Code sufficiently resembles legislation as to be likewise regarded as demanding construction of its provisions by a judge'.

<sup>99</sup> J. Black, 'Regulatory Conversations' (2002) 29 *Journal of Law and Society* 163.

and understandings. Others have referred to such shared context that informs meaning and understanding as 'interpretive communities'.<sup>100</sup> While the possible regulatory conversations associated with the Takeover Code have not been subject to detailed empirical research, for this author, building on his practical experience as a corporate lawyer, there is such a Takeover Code conversation and community that makes a considerable contribution to the reliability and certainty of advice on the Code when given by seasoned advisors.

The Code is an autonomous body of rules. While it forms part of this book on company law and is a central aspect of regulation of the transfer of shares and the protection of shareholders as a result of takeover activity it is *not* a part of what traditionally we would understand as UK company law. The rules and principles which we find in company law cases and the Companies Act 2006 do not control the meaning of the words, rules and principles set out in the Code, although they may be useful, and indeed influential, in understanding certain words and concepts found in the Code. This position was stated authoritatively by the Takeover Appeal Board in the case of *Eurotunnel Plc*.<sup>101</sup> In this case, shareholders who had been granted certain travel privileges on Eurotunnel claimed, in the context of an offer for their shares, that they should be treated as holding a separate class of shares which would then require that the bidder take into account these privileges in determining the amount offered for their shares.<sup>102</sup> Both the Panel Executive and the Hearings Committee rejected the claim and the shareholders appealed to the Appeal Board. To substantiate their argument the shareholders relied upon two cases: *Soden v British & Commonwealth Holdings plc*,<sup>103</sup> a case in which the claimant asserted that misrepresentations made by the company were made to him in his 'character as a member' for the purposes of the Insolvency Act 1986, and *Cumbrian Newspapers Group Ltd v Cumberland & Westmorland Herald Newspaper & Printing Co Ltd*, a case considered in depth in Chapter 17, which involved the question of whether certain rights were 'rights attached to a class of shares' for the purposes of section 125 of the Companies Act 1985, which is now section 630 of the Companies Act 2006. The Appeal Board considered the cases and found the shareholders' reliance upon them unpersuasive. More importantly, the Appeal Board approved of the Hearing Committee's position in this case on the relationship between company law and the Takeover Code, which was as follows:

It is not the function of the Panel to make determinations of law, still less to challenge conclusions of law reached in the courts. Its function is to interpret and apply the provisions of the Code according to their purpose and intent. In doing so it will not disregard statements of law which may be helpful but in the end must seek to apply the Code itself. Thus, in the present case it is not considered that the conclusions in the *Soden* and *Cumbrian* cases can be determinative of the meaning of phrases inserted in the Code. Whether a court would on the facts of the present case regard the Travel Privileges as 'rights attached to a class of shares' for the purposes of section 125 of the Companies Act 1985, or as being held in 'the character of a member' for the purposes of section 74 of the Insolvency Act 1986 is something upon which the Committee expresses no view. It is simply noted that the answer is not obvious as the Appellants suggest, and even if it were it would still be necessary to consider the terms of the Code, its purposes and its intention.

<sup>100</sup> S. Fish, *Is there a Text in this Class? The Authority of Interpretative Communities* (MA, Harvard, 1980).

<sup>101</sup> *Eurotunnel Plc* (Takeover Appeals Board 2007/2).

<sup>102</sup> This case is considered in depth below at Web Chapter A, pp 57-59..

<sup>103</sup> [1998] AC 298.

According to the Appeal Board in *Eurotunnel*, company law may be helpful but does not impinge on the autonomy of the Code and the meaning of its rules. However, in certain respects the autonomy of the Code has been qualified as a result of the fact that the Code and the Takeover Panel now represent the UK's implementation of the Takeover Directive. In interpreting the Code, the Takeover Panel must therefore – as do the courts when interpreting primary or secondary legislation that implements a Directive – take a purposive approach to interpretation that, if possible, ensures compliance with the Directive.<sup>104</sup> This approach not only results in interference with Code autonomy by the Directive but also, in some instances, opens a wider door for more direct interference by company law. Consider in this regard, for example, the meaning of the 'company as a whole' for the purposes of the General Principle 3's requirement that the board of directors of the target company must act in 'the interests of the company as whole'.

The Old General Principles referred not to 'the interests of the company as a whole' but to 'the shareholders' interests taken as a whole, together with those of employees and creditors', suggesting priority for shareholders but consideration of employee and creditor interests. Does the change in language imply any change in the priority given to different constituencies in the context of a takeover bid – a possible elevation of employee and creditor interests? Certainly, the Directive itself is the product of the approaches to company law of multiple EU jurisdictions, many of which do not explicitly elevate the interests of shareholders above the interests of other constituencies.<sup>105</sup> Also the New General Principles themselves make additional reference to the concerns of employees arising out of takeover activity (New General Principle 2). The phrase 'company as a whole' clearly allows Member States to take account of their different conceptions of the company and of the company's interests, whether that involves a shareholder oriented or multiple-interest approach.<sup>106</sup> In the UK, the concepts 'interests of the company' and 'company as a whole' are familiar from both the consideration of the common law duty for directors to act in good faith in the best interests of the company<sup>107</sup> as well as from the obligation imposed on the general meeting to act bona fide for the benefit of the company as a whole.<sup>108</sup> In the context of directors' duties at common law the 'company's interests' meant the present and future shareholder interests, unless the company was insolvent or approaching insolvency in which case creditor interests would

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<sup>104</sup> In *Lister v Forth Dry Dock & Engineering Co Ltd* [1989] 2 WLR 634 Lord Oliver of Aylmerton made the following observations in this regard: 'my Lords, this appeal raises, not for the first time, the broad question of the approach to be adopted by courts in the United Kingdom to domestic legislation enacted in order to give effect to this country's obligations under the EEC Treaty... The approach to the construction of primary and subordinate legislation enacted to give effect to the United Kingdom's obligations under the EEC Treaty have been the subject matter of recent authority in this House (see *Pickstone v Freemans Plc* [1989] AC 66) and is not in doubt. If the legislation can reasonably be construed so as to conform with those obligations – obligations which are to be ascertained not only from the wording of the relevant Directive but from the interpretation placed upon it by the European Court of Justice at Luxembourg – such a purposive construction will be applied even though, perhaps, it may involve some departure from the strict and literal application of the words which the legislature has elected to use.'

<sup>105</sup> In relation to Germany, see U. Hueffer, *Aktiengesetz* (7<sup>th</sup> edn, 2006, C.H. Beck).

<sup>106</sup> See further Chapter 10, section II.

<sup>107</sup> See Chapter 10.

<sup>108</sup> See Chapter 16.

intrude.<sup>109</sup> Other constituency interests, at common law as well as under the section 172 duty to promote the success of the company, are subordinate to the interests of the shareholder body. This meaning is also in accordance with the Code's previous approach, and must be the correct one. It is a fine and moot point, however, whether this conclusion is reached with the 'help' of or through direct reliance upon company law.

## 2 *Scope of application of the Code*

There are two questions to answer to determine the scope of application of the Takeover Code: first, which companies does the Code apply to, and in relation to what transactions does the Code apply? We answer these questions in turn.

The companies that are subject to the Takeover Code in relation to bids made for the shares in those companies are set out in section 3 of the Introduction to the Code.<sup>110</sup> The primary constituency of companies which are subject to the Code are UK public companies listed on a UK regulated market<sup>111</sup> the most important of which is the Main Market of the London Stock Exchange. However, the Code also applies to unlisted public companies that are headquartered ('place of central management and control') in the UK and even private UK companies that are headquartered in the UK and that were publicly traded or listed in the previous 10 years. However, the Code notes that application of the Code may not be appropriate to such private companies and will, therefore, be applied flexibly by the Panel in relation to such companies.

In relation to the above companies the Panel has sole jurisdiction. In relation to certain other companies the Panel may exercise shared jurisdiction with another EU Member State supervisory authority. Shared jurisdiction involves only certain provisions of the Code applying to certain companies. These companies include UK registered companies that trade on a regulated market in the European Economic Area (EEA) but not in the UK, and companies that are non-UK EEA registered companies which are traded on a UK regulated market but not on a regulated market in their home countries. Companies falling in the first category are subject to what is referred to as the employee information and company law aspects of the Code (including the determination of whether a mandatory bid is required),<sup>112</sup> whereas companies in the latter category are subject only to the consideration (pricing) and procedural aspects of the Code.<sup>113</sup> What is covered by such aspects of the Code will become clear as we progress with our detailed analysis of the Code below.

Paragraph 3(b) of the Introduction to the Takeover Code provides that the Code is concerned with 'regulating takeover bids and merger transactions of the relevant companies, however effected'. This would include a takeover implemented by way of a contractual share sale involving a direct offer to purchase shares made by the bidder to target company shareholders, but it would also include a share sale or merger effected by way of a scheme of arrangement. We will address schemes of arrangement separately in Part C of this chapter. Accordingly, for the purposes of the remaining analysis of the Takeover Code in this section

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<sup>109</sup> See Chapter 18.

<sup>110</sup> This provision of Panel jurisdiction implements Article 4(2) of the Takeover Directive.

<sup>111</sup> 'Regulated Market' is defined in EU Directive on Markets in Financial Instruments (2004/39/EC) Article 4.1(14). See further Web Chapter C.

<sup>112</sup> On the mandatory bid see Web Chapter A, B.III below.

<sup>113</sup> Takeover Code, Introduction, section 3(a).

we shall restrict our analysis to a takeover bid implemented by a direct contractual offer from the bidder to target shareholders to purchase their shares.

### 3 *Announcing a takeover bid*

The process leading up to a takeover bid involves several stages: (1) the identification of a possible target for the bidder company; (2) the initial informal approach by the bidder to the board of directors of the target; and, (3) where the target board is interested in the bid, the provision by the target of confidential/proprietary information by the target to the bidder. The bidder will employ several different advisors during this period to examine thoroughly the available information in order to assess the value of the target and the risks (both financial and legal) associated with the purchase. This process is known as **due diligence** (financial, operational and legal).

It is likely that during this period the boards of directors of the target and the bidder will engage in negotiations to reach what both the boards view as an appropriate price. If the bid is structured as a takeover offer direct to shareholders there is no need to reach agreement with the target board on price and terms but the support of the target board increases the likelihood that target shareholders will accept the offer. This initial process of due diligence and negotiation is likely to take place under a veil of secrecy. Secrecy is important for the bidder as he does not want to attract the attention of other potential bidders for the target company. To the extent that secrecy can be maintained the chances of the bidder acquiring the company are higher than they would otherwise be. Bidding for companies is an expensive process involving significant financial costs as well as the **opportunity costs** involved in pursuing this company as opposed to an alternative target. The bidder's willingness to incur such costs will be a function of its assessment of whether it will be able to successfully complete the acquisition. The target may also be willing to maintain this veil of secrecy for several reasons: management may view the other potential bidders in the market as less suitable or appropriate fits with the company and similarly do not want to attract these other possible bidders' attention; or they may wish to commit to secrecy to ensure that the existing bidder does not walk away. Where no formal announcement has been made that a bid is being considered or proposed, secrecy is also important for the financial markets. Unconfirmed information leaking into the market place may result in considerable volatility in the target company's share price as unconnected market participants speculate about the likelihood of a bid and the possible premium offered above market price.

The Takeover Code stresses the importance of secrecy prior to an announcement of a possible or a proposed bid. Rule 2.1 provides that:

#### **Takeover Code, Rule 2.1**

The vital importance of absolute secrecy before an announcement must be emphasised. All persons privy to confidential information, and particularly price-sensitive information, concerning an offer or contemplated offer must treat that information as secret and may only pass it to another person if it is necessary to do so and if that person is made aware of the need for secrecy. All such persons must conduct themselves so as to minimise the chances of an accidental leak of information.

During this initial period of due diligence and negotiation there is no legally binding commitment of the bidder to make an offer to the company. It is important, however, for the target company to have clarity as to when and if the bid is going to be made. The bid process is distracting for management and employees both in terms of the time invested in providing information to and talking to the bidder, but also psychologically as management and employees feel uncertain about their future. These distractions can destroy value as the company 'takes its eye off the [value generation] ball'. A company that goes through the process of talking seriously to a bidder for a protracted period only for the bidder to walk away is unlikely to be in as strong a position as it was prior to the approach. To force the bidder to make a bid within a particular time-frame, the target board could condition their openness and support for any bid on the bidder making a decision within a specified time-frame; however, this may not be successful as the bidder could still make a bid direct to shareholders even if the target board withdrew its support. We saw above in relation to General Principle 3 that the



Code takes account of this concern by requiring that the 'company must not be hindered in the conduct of its affairs' for longer than is reasonable. This is sometimes referred to as the 'siege principle'. The Code specifically addresses this issue in Rule 2 by requiring that in certain circumstances an announcement is made and authorizing the Panel, upon application by the target company, to set a time-frame within which the bidder must make a decision as to whether or not to make an offer.

Rule 2.2 sets out various situations when an announcement must be made. It requires an announcement: (1) where the board is informed that the bidder has a firm intention to make an offer; (2) where, whether or not the target board has been approached by the bidder, the target company's shares are the subject of 'rumour and speculation' or there is an 'untoward movement' in the company's share price; (3) where an investor crosses the 30% ownership threshold requiring a mandatory bid or where such an investor is sought by the target company itself;<sup>114</sup> or (4) where the discussions and negotiations surrounding a bid are to be extended beyond a restricted number of individuals.

We see in regard to the 'rumour and speculation' and 'untoward movement' in share price category how the Takeover Panel asserts direct control over a takeover transaction at a very early stage in its development. What amounts to 'untoward movement' is for the Takeover Panel to determine.<sup>115</sup> Where there are unusual movements in the share price, this necessarily requires that the Takeover Panel be informed of the possible bid to obtain their view. The failure to inform the Panel and to make an announcement in circumstances which in the Takeover Panel's (ex-post) view amounted to 'untoward movement' would be a breach of the Code. In this regard the Notes to Rule 2.2 provide that consultation with the Panel will normally be necessary where there is 10% movement in the share price from the time when the target board was approached, where there is a sharp rise of 5% in a single day, or where there is any other abrupt movement in price.<sup>116</sup>

Where an announcement has to be made or where the bidder otherwise elects to make an announcement, there are two possible forms of announcement: an announcement of a *possible offer* under Rule 2.4; or the announcement of the firm intention to make an offer under Rule 2.5. Before we address these announcements in detail note, as an example of the extent of the detailed regulation that the Code imposes on takeover bids, that Rule 2.3 addresses the distribution of responsibility between target and bidder boards for making the announcement: prior to the approach to the target company board such responsibility obviously rests with the bidder, but after any approach<sup>117</sup> primary responsibility rests with the target board.

Under Rule 2.4, the obligation to make an announcement of a *possible offer* is satisfied by the straight forward statement that talks between the parties are taking place or that the bidder is considering making an offer. However, care must be taken in this announcement because if the announcement contains a statement as to the terms of a possible bid the bidder will be bound by the terms of such a statement if it subsequently makes an offer, unless the announcement explicitly reserved the right not to be bound by those terms.

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<sup>114</sup> On the mandatory bid see Web Chapter A, B.III below.

<sup>115</sup> Takeover Code, Notes to Rule 2.2, note 1.

<sup>116</sup> Takeover Code, Notes to Rule 2.2, note 1. For further clarification on share price movements and announcements see Practice Statement No 20: Rule 2 – Secrecy, possible offer announcement and pre-announcement responsibilities (2008), para 5.

<sup>117</sup> With regard to what bidder action amounts to an 'approach' see Practice Statement No 20: Rule 2 – Secrecy, possible offer announcement and pre-announcement responsibilities (2008), para 3.

Whilst the announcement of a possible offer may address some of the volatility in the market place – although clearly not all given the lack of certainty about the offer and its terms – from the target company's perspective the problem identified above, that management and employees continue to be distracted by a possible offer that may never actually materialize, remains. The Code addresses this by giving target companies the right to ask the Panel to issue a 'put-up or shut-up' ruling.<sup>118</sup> In response to such a request the Panel may impose a time-limit within which the bidder must announce a firm intention to make an offer or make a statement that it does not intend to make an offer. If the bidder makes a statement that it does not wish to make an offer then it may not for the following six months: make an offer for the company; make any statement suggesting that it could make an offer; or acquire shares in the company that would result in it having to make a mandatory bid.<sup>119</sup> These restrictions also apply to anyone 'acting in concert' with the bidder, the definition of which we consider in B.III below. A considerable majority of the Panel Executive's rulings involve such put-up or shut-up rulings.<sup>120</sup> Consider, for example, the Panel Executive's ruling in relation to the, at the time, possible bid by Kraft Food Inc for Cadbury Plc.

#### **The Takeover Panel (2009/23)**

##### **Kraft Foods Inc. ('Kraft Foods')**

Following recent representations made by the advisers to Cadbury, the Panel Executive has been considering the application of Rule 2.4(b) of the Code to the announcement made by Kraft Foods, on 7 September 2009, in respect of Cadbury. Following discussions with both parties' advisers, the Panel Executive has ruled that, unless the Panel Executive consents otherwise, Kraft Foods must, by 5.00 p.m. on 9 November 2009, either announce a firm intention to make an offer for Cadbury under Rule 2.5 of the Code or announce that it does not intend to make an offer for Cadbury. In the event that Kraft Foods announces that it does not intend to make an offer for Cadbury, Kraft Foods and any person(s) acting in concert with it will, except with the consent of the Panel Executive, be bound by the restrictions contained in Rule 2.8 of the Code for six months from the date of such announcement. Each of the parties has accepted this ruling.

30 September 2009

A bidder who announces a firm intention to make an offer must do so in accordance with the terms of Rule 2.5, which regulates the contents of the announcement. The document making the announcement is known colloquially by advisors as 'the two-five' and is a document of considerable importance as, subject to certain factors, it binds the bidder to making an offer in accordance with the stated terms.

Pursuant to Rule 2.5 an offer should only be made 'when an offeror has every reason to believe that it can and will continue to be able to implement the offer'. The announcement must contain details of the terms of the offer,<sup>121</sup> which would include the price to be paid and the form of consideration as well as information on the identity of the bidder. The

<sup>118</sup> Takeover Code, Rule 2.4(b).

<sup>119</sup> Takeover Code, Rule 2.8.

<sup>120</sup> Apart from two extensions to the offer timetable, all Executive rulings made in 2009 all related to *put-up* or *shut-up* rulings. See <http://www.thetakeoverpanel.org.uk/statements/panelstatements/ps2009>.

<sup>121</sup> The Code's requirements for what must be included in the rule 2.5 announcement are set out in Rule 2.5(b).

announcement must also contain details of any conditions to which the offer will be subject as *well* as any pre-conditions to which the making of the offer will be subject. The Code is very suspect of all such offer and pre-offer conditions (on *offer conditions* see II.6 below). Any pre-conditions to the making of the offer must be cleared with the Panel unless they relate to whether or not there will be a reference to or clearance from competition authorities<sup>122</sup> or other regulatory authorities.<sup>123</sup> Any pre-conditions allowed by the Panel will only be allowed to be invoked where the Panel determines that the failure to comply with the condition is of 'material significance to the offeror in the context of the deal'. Furthermore, Rule 13.4(b) requires the bidder to use 'all reasonable efforts' to obtain compliance with the preconditions.

While the Panel may grant approval for such offer preconditions they strictly police any attempts to introduce other pre-conditions which were not mentioned in the Rule 2.5 announcement in order to delay the making of the offer in accordance with Rule 30.1 of the Code, which requires that the offer is made within 28 days of the Rule 2.5 announcement or the fulfilment of any permitted pre-condition to making the offer. In this regard consider the following Hearings Committee ruling.

### **The Takeover Panel (2008/46)**

#### **Offer By Jarpeno Limited ('Jarpeno') (A Wholly-Owned Subsidiary Of Ongc Videsh Limited ('Ovl'))**

#### **For**

#### **Imperial Energy Corporation Plc ('Imperial Energy')**

#### **Hearings Committee's Reasoned Decision**

##### ***The issue***

Whether or not an extension of the Code time limit for the posting of the offer document should be granted.

##### ***The parties***

The parties to the appeal were:

(1) ONGC Videsh Limited. OVL is a wholly-owned subsidiary of Oil & Natural Gas Corporation Limited ('ONGC'), a company listed on the National Stock Exchange and Bombay Stock Exchange in India. The Government of India is ONGC's major or controlling shareholder, having a 74% interest.

(2) Imperial Energy Corporation PLC. Imperial Energy's operations are focused on the Commonwealth of Independent States and, in particular, the Russian Federation. Imperial Energy is listed on the Official List of the London Stock Exchange.

(3) The Panel Executive.

##### ***The background***

1. On 26 August 2008, the boards of OVL and Imperial Energy announced the terms of a recommended cash offer to be made by a wholly-owned subsidiary of OVL, Jarpeno, for the entire issued and to be issued share capital of Imperial Energy (the 'Offer').

The Offer... valued Imperial Energy at £1.4bn. The Offer was a pre-conditional cash offer. It specified only two preconditions to the posting of the offer document. These

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<sup>122</sup> Takeover Code, Rule 13.3(a) and (b).

<sup>123</sup> Pursuant to Takeover Code, Rule 13.3(c) such other regulatory pre-conditions may only be invoked where the board recommends the bid or where the Panel is satisfied that such approval will not be available within the Takeover Code offer timetable.

related respectively to Russian anti-monopoly and Russian foreign investment clearances. No mention was made of any need for Indian Government approval.

2. The announcement was in the form of a firm commitment to make an offer and so was subject to Rule 2.5(a) of the Code...

3. On 11 November 2008, OVL announced that the pre-conditions to the offer specified in the announcement had been satisfied. Accordingly, pursuant to Rule 30.1 of the Code, the 28-day period within which the offer document should normally be posted to Imperial Energy shareholders was due to expire at midnight on Tuesday 9 December 2008.

4. On 4 December 2008, OVL sought an extension from the Executive on behalf of the Panel of the time limit for posting the offer document to 19 December 2008 to enable the approval of the Indian Government to the posting of the offer document to be obtained. [Rule 30.1 of the Code provides that the offer document must, unless Panel approval is obtained, be posted within 28 days of the making of the Rule 2.5 announcement.]

[There was no pre-condition for Indian Government approval in the Rule 2.5 announcement. The Indian Government subsequently requested the right to review and approve the offer document, and OVL felt compelled to comply with this request as it is majority owned by the Indian Government. OVL claimed that as a result of the Mumbai terrorist attacks in late November 2008 the Indian Government had been understandably distracted from carrying out this review in a timely fashion.]

#### ***The Executive's submissions***

10. The Executive submitted that no extension of the time limit should be granted. In support of this conclusion, it pointed to the distinction in the Code between an announcement of a firm intention to make an offer under Rule 2.5 and an announcement of a possible offer under Rule 2.4. The former represents a formal commitment to proceed with an offer and, as such, will almost inevitably have a profound effect upon the offeree company and the market price of its shares – hence the need for care on the part of both an offeror and its financial adviser (ahead of the release of a Rule 2.5 announcement) and the compelling terms of Rule 2.7.

11. The Executive further pointed to one of the ‘principal objectives’ of the Code which is to provide an orderly framework for the conduct of offers, including the specified timetable within which steps must be taken after a Rule 2.5 announcement. It argued that the rationale behind the timetable is that the offeree company should not be exposed to an excessive period of siege, and that in practice an extension of time for the posting of the offer document would not be granted unless the offeree consented (which it had not done in this case).

This ‘siege principle’ is stated in General Principle 6 of the Code (as it is in the Takeovers Directive) as follows:

‘An offeree company must not be hindered in the conduct of its affairs for longer than is reasonable by a bid for its securities.’

The Executive pointed out that the Rule 2.5 announcement, itself approved by the Indian Government, plainly recognised (in paragraph 16) OVL’s obligation under the Code to comply with Rule 30.1 and post the offer document within 28 days of satisfaction or waiver of the pre-conditions.

12. The Executive stressed that not only did the announcement make no reference to the need for the approval of the Government of India, but indeed, if any such approval had to be obtained, no Rule 2.5 announcement could have been made at all since a pre-condition to this effect would not have been permitted under Rule 13.3 of the Code.

13. The Executive noted that OVL's advisers confirmed to the Executive on 18 August 2008 that, at the point of issuing the Rule 2.5 announcement, Jarpeno would 'be able to implement the proposed offer without recourse to or consent from the Indian Government, ONGC or OVL' and confirmed to the Executive on 22 August 2008 that the Government's consent had been obtained.

#### ***The decision***

20. The Committee concluded that the Executive's arguments were compelling and dismissed OVL's appeal.

21. Without re-stating those arguments in detail, the Committee wishes to reiterate the importance of treating a Rule 2.5 announcement as a firm commitment to make an offer in accordance with the terms of the announcement and to follow the Code timetable unless and to the extent that the Panel modifies such obligations, something which all concerned would rightly expect to happen only in exceptional circumstances and with the consent of the offeree, at least in the event, as here, of a recommended offer. After a Rule 2.5 announcement, to attempt to introduce unilaterally a pre-condition to the offer is manifestly unacceptable...

24. The Committee is pleased to note that, following its decision, the offer document has been posted within the timetable imposed by the Code.

11 December 2008

Through Rule 2.5, the Code<sup>124</sup> ensures that if a firm announcement is made then, subject only to the fulfilment of the allowed pre-conditions to the making of the offer, the offer must be made. The Panel, as we see in the above abstract, is unlikely to grant permission not to make an offer in the absence of a stated pre-condition that has not been fulfilled.<sup>125</sup> Central to this ability to insist on the offer being made is the availability to the bidder of the consideration required to implement the offer. 'Tough talk' from the Takeover Panel about how the offer must be made by the bidder would carry little weight where the bidder, who, for example, intended to make a cash bid, does not have the funds available to carry out the offer and is incapable of raising those funds in the market place. Of course such a bidder and his advisors would be disciplined by the Panel but the Panel would be powerless to insist that the bid go ahead. To ensure that this situation does not arise Rule 2.5 provides that where the intended offer is a cash offer the bidder's financial advisor must provide a 'cash confirmation' that confirms that the funds are available to complete the offer.<sup>126</sup> Rule 2.5 also provides, by implication, that if the financial advisor has not acted reasonably in giving that confirmation it may be liable to make the funds available itself. In practice, this means that the financial advisor will not give this confirmation without the funds being placed in a bank account in the control of the advisor or, more commonly, that the other banks providing the finance to make the offer provide enforceable 'commitment letters' that they will make the funds available.

## ***4 The terms of the voluntary offer: equality of treatment***

The introduction to the Takeover Code provides that the Code is 'designed principally to ensure that shareholders are treated fairly'. Principle 1 of Takeover Code's New General

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<sup>124</sup> Together with Rule 2.7 of the Code *Consequences of a 'Firm Announcement'* which states that where a Rule 2.5 announcement has been made then, subject to approved pre-conditions being complied with, the offer must proceed.

<sup>125</sup> See also Takeover Panel (Executive) Ruling in relation to Freeport Plc (2007/25).

<sup>126</sup> Takeover Code, Rule 2.5(c).

Principles provides that shareholders of the same class shall be afforded 'equivalent treatment'. The Old General Principle 1 provided that such shareholders be treated 'similarly'. The approach suggested by these terms appears consistent with English company law's commitment to fair treatment among shareholders and not necessarily equal treatment between shareholders within the same class.<sup>127</sup> However, the choice of term should not be misunderstood. The Takeover Code has a stronger and much clearer commitment than UK company law to equal treatment of shareholders. Indeed in several rules the Code refers explicitly to equality of treatment.<sup>128</sup> In this regard consider the following extract which considers the meaning of 'equality' in the takeover context.

**P. Davies, 'The Notion of Equality in European Takeover Regulation' in J. Payne and D. Prentice, *Takeovers in English and German Law* (Hart, 2002)**

In the takeover context the equality principle is essentially a sharing rule. The consideration which the acquirer is prepared to pay for control of the target company should be shared equally among shareholders of the same class and proportionately among shareholders of different classes. However, the equality rule arises for consideration in a wide range of circumstances within take-over bids. In order to begin to identify the function of the notion of equality in this area, it is helpful to set out [two]<sup>129</sup> broad circumstances (or sets of circumstances) where the equality notion could be deployed by rule-makers in relation to take-overs. First, the rules could require equality among those to whom the offer is made. Thus, it could be stipulated that all members of the same class of shareholder should be made the same offer; that members of different classes of shareholder should be made comparable offers; and that increases in the offer made in the course of the bid should be extended to those shareholders who have accepted the earlier, lower offer. More controversially, it could be required that the emergence of a competing offeror permit shareholders to resile from their acceptances of the rival, but lower offer. This can be referred to as equality *within the bid*.

Second, the equality notion could be extended so as to embrace equality between those who accept an offer and those who sell to the bidder outside the offer process. Thus, if a bidder buys shares in the market during the offer period but at a higher price, it could be required to raise the offer price to the level of market purchases and perhaps also, if it is not already a cash offer, to provide a cash alternative. This can be referred to as equality *between offerees and sellers outside the offer*. The most intriguing issue in this area is whether the rule should be confined to those who sell outside the offer but during the offer period or whether purchases by the offeror prior to the formal offer should have any influence on the level or type of consideration required to be offered in the bid. In a large-scale bid the acquirer's strategy is likely to couple a public offer to all the shareholders with the pre-bid acquisition, through the market, of as large a 'launch-pad' shareholding in the target as the acquirer can manage without revealing the subject of its intended offer. So, the issue of the impact of prior purchases on the equality principle is an important one in practice.

<sup>127</sup> Section 172(1)(f) requires that directors have regard to the 'need to act fairly as between members of the company' restating the holding in *Mutual Life Insurance Co of New York v Rank Organisation Ltd* [1985] BCLC 11.

<sup>128</sup> See Takeover Code, Rules 11.1, 11.2 and 15(a).

<sup>129</sup> Professor Davies sets out three rather than two broad circumstances. We consider only two here; the third addresses the making of mandatory offers considered in IV below.

## 4.1 Highest price rule for the same class of shares

Let us consider first of all the Takeover Code's regulation of equality *within* the bid. With regard to shareholders of the same class of shares, the Code provides, albeit indirectly, that a voluntary bid<sup>130</sup> must be made for all classes of shares in the target as well as all securities convertible into shares. It does this by providing for an exception from the application of the mandatory bid rule – which requires that a bid must be made if an investor crosses the 30% ownership threshold<sup>131</sup> – where the bid is made to all holders of voting share capital and 'transferable securities carrying voting rights'.<sup>132</sup>

Rules 6.2 and 32.3 of the Code ensure that during the course of the bid all shareholders are offered, and those who accept the offer receive, an amount per-share for their shares that equals the highest price paid to any shareholder during the course of the bid.<sup>133</sup> Rule 32.3 provides that if the offer is revised – which may occur where it is clear to the bidder that the original offer is not attracting sufficient acceptances – then all shareholders who have already accepted the offer<sup>134</sup> are entitled to the revised consideration.<sup>135</sup> Rule 6.2 ensures that if

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<sup>130</sup> A voluntary bid is sometimes referred to colloquially as a Rule 10 offer. Section G of the Code regulates 'The Voluntary Offer and its Conditions'. Rule 10: The Acceptance Condition is the first rule in Section G.

<sup>131</sup> Set out in Rule 9 and considered in detail in Web Chapter A, B.III below.

<sup>132</sup> Takeover Code, Rule 9.1(b).

<sup>133</sup> The rule applies to any shares purchased following the Rule 2.5 announcement. The rule applies not only to purchases of actual shares but to purchases of 'interests in shares'. The term 'interests in shares' is the subject of a comprehensive definition in the Code (interests in shares falls within the umbrella definition of 'interests in securities') – see Takeover Code, Definitions. 'Interests in shares' covers both the share but also any option or derivative instrument whose value is determined by reference to the share price and which 'may result' in the ownership of the instrument following the settlement of the derivative position. This would include long positions in so called 'contracts for difference' or 'CFDs' (known as equity-swaps in the US) which are contracts whereby a counterparty agrees to pay to the buyer of the CFD the difference between the value of the share at the contract date and its value on a specified future date(s); if the value of the share falls below its value on the contract date the buyer will pay the counterparty the fall in the value and vice versa. Such a contract for difference involves no equity ownership but provides the buyer with the economic equivalent of owning the share. The person selling the contract for difference – typically an investment bank – will hedge its position by buying the share itself (if the share goes up it makes an equivalent sum to that payable under the CFD; if it goes down what it loses is repaid by the CFD buyer) and when the CFD is settled – amounts payable by seller or buyer paid – the buyer will often take delivery of the actual share – although there is no contractual obligation from the seller to provide for delivery. The Takeover Code's definition of 'interests in securities' captures such CFDs as it includes any derivative instrument that 'may result' in ownership of the share.

<sup>134</sup> Note that this consideration equality rule applies only to shareholders who accepted the offer, not to any shareholders who agreed to sell their shares outside of the offer.

<sup>135</sup> Note that, pursuant to Rule 32.2 of the Code if, in an attempt to persuade shareholders to accept the offer, a bidder makes a statement such as 'the offer price will not be increased' or 'our offer will not be raised' then the bidder will not, without the consent of the Panel, be allowed to raise the price or change the terms of the bid – unless such a right was reserved when the statement was made – which would of course rather

during the course of the offer the shareholder pays any shareholder<sup>136</sup> an amount in excess of the offer consideration for their shares then such a higher price must be offered to all shareholders.<sup>137</sup> Of course additional consideration can be paid in other forms than simply more of the type of consideration offered to all shareholders as part of the offer. Management who are also shareholders, for example, could be offered above market remuneration if they remain as managers in the company following the completion of the takeover. The Code addresses this in Rule 16 which prohibits separate arrangements with any shareholders providing for more favourable conditions than those offered to other shareholders without Panel's consent. In relation to remuneration deals with management to retain their services post-takeover, Rule 16.2 requires that details of the arrangements with target management must be disclosed and a statement must be provided by the target company's independent<sup>138</sup> advisor that the terms of the arrangements are fair and reasonable.

## 4.2 Equality with pre-bid purchases

We have seen above that Rules 6.2 and 32.3 provide that the bidder must offer all shareholders the highest price paid for any share or 'interest in shares' after the announcement of the bid. This is a central component of ensuring that shareholders are treated equally within the bid. With regard to price regulation the Code goes further than this to ensure, to a qualified degree, that shareholders who are subject to the offer receive equal treatment to those shareholders who sold their shares in the run up to the announcement of the intention to make the bid. Rule 6.1 provides that the voluntary offer to shareholders must be as favourable as the terms of any share purchase in the *three months* prior to the commencement of the offer and prior to that if, 'in the view of the Panel there are circumstances which render such a course necessary to give effect to General Principle 1'. The Panel will normally not impose a time-period greater than three months unless the directors of the target or bidder are the parties that sold the shares.<sup>139</sup> This ensures, in particular, that the directors of the target are not 'bought off' to persuade them to recommend the bid to shareholders with pre-three month 'sweetheart' terms. Note that this three-month period contrasts with the 12-month pre-announcement period<sup>140</sup> imposed both in the context

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undermine the intended effect of making the statement (see Note 2 to Rule 32.2). The Panel will only grant its consent in 'exceptional circumstances'. However, if another competitive bid is made after the bidder has made such a no increase statement then the bidder may choose not to be bound by his no-increase statement (Note 3 to Rule 32.2).

<sup>136</sup> The Takeover Code does not impose a prohibition on the acquisition of target shares outside of the offer during the offer period by the bidder (Rule 7). The bidder is required to disclose the numbers of shares purchased and the price paid (Rule 7). This contrasts with some jurisdictions, such as the US, which impose a prohibition on dealings in target shares by the bidder during the course of the bid (Rule 14e-5 Regulation 14E issued pursuant to the Securities Exchange Act 1934).

<sup>137</sup> Note that this highest price obligation includes the price paid by parties 'acting in concert' with the bidder. On the definition of 'acting in concert' see Web Chapter A, pp 97-98 below.

<sup>138</sup> Independence is not defined by the Code.

<sup>139</sup> Takeover Code, Note to Rule 6, para 2.

<sup>140</sup> Takeover Code, Rule 9.5.



of a mandatory bid pursuant to Rule 9, which is discussed in further detail below, and also where a cash offer is required by Rule 11 (see II.4.5 below).

### 4.3 Comparable offers for different classes of share

Where the target company has more than one class of shares the different classes of shares will have different financial claims and/or voting rights.<sup>141</sup> Such different share classes will, therefore, have different values reflecting these differing financial claims and control rights. What then is involved in providing 'fair' and 'equivalent' treatment for such shareholders when making an offer? Rule 14 of the Code provides that holders of different classes of shares should receive 'comparable' treatment.

#### **Takeover Code, Rule 14**

##### **14.1 Comparable offers**

Where a company has more than one class of equity share capital, a comparable offer must be made for each class whether such capital carries voting rights or not; the Panel should be consulted in advance. An offer for non-voting equity share capital should not be made conditional on any particular level of acceptances in respect of that class, or on the approval of that class, unless the offer for the voting equity share capital is also conditional on the success of the offer for the non-voting equity share capital. Classes of non-voting, non-equity share capital need not be the subject of an offer, except in the circumstances referred to in Rule 15.

##### **14.2 Separate offers for each class**

Where an offer is made for more than one class of share, separate offers must be made for each class.

Rule 14 provides that a separate offer must be made for each class of shares and that across all such share classes the offers must be comparable. Importantly, this means that it is not possible, as it is in other jurisdictions such as the US,<sup>142</sup> to make an offer for only one class of share even if, because of the distribution of voting rights, the purchase of only one class of shares would give the bidder control over the company.

When considering why the Code imposes such a requirement we must disentangle the commitment to equal treatment from the Code's commitment to enable security holders to exit following a change of control in the company. The requirement to make an offer for all classes of shares can be understood in equal treatment terms – if one equity security holder receives an offer so should the others – but this rationale is suspect. If investors buy a class of shares in a company that have, for example, no voting rights they will pay less for those shares to take account of the lack of voting power. In an *unregulated* takeover environment one of several reasons why they would pay less for those shares would be to take account of the fact that those shares are less likely to be the subject of a takeover bid because they do not affect control. If you pay less for those shares to take account of that fact then there is no inequality of treatment if you do not receive an offer for those shares when a bidder makes an

<sup>141</sup> On classes of shares and the nature of financial claims and voting rights see Chapter 17 pp 643-50 and 668–76.

<sup>142</sup> Rule 14d-10(a) issued pursuant to the Securities and Exchange Act 1934 requires that an offer must be made to all the holders of the same class of shares but does not impose an obligation to make an offer in relation to other or all classes of share. The regulation of the takeover process in the US is found in the Securities Exchange Act of 1934. The provisions of this Act that address takeovers are sometimes referred to as 'the Williams Act' which was the 1968 Act that amended the Securities Exchange Act 1934 to include the takeover regulation.

offer for the voting shares. A more persuasive rationale for this requirement is found in one of the Code's other driving principles: ensuring that all security holders have an opportunity to exit on a change of control rather than be exposed to the possible abuse of power by a future controlling shareholder (New Principle 1; Old Principle 10). We shall explore this rationale in greater depth below in B.III when we consider its clearest incarnation in the form of the mandatory bid rule. Note here in particular, that the strength of this rationale is a function of how well other company law mechanisms operate to prevent such abusive behaviour. If such other mechanisms are effective in controlling such behaviour then the rationale for this rule is weakened. If we feel the rationale for the rule is weak – whether the rationale is based on equality of treatment or minority protection – we should then pay closer attention to the possible costs of such a rule. In this regard the cost of such a rule is that it may sharply increase the costs of obtaining control and *may* therefore reduce the supply of control entrepreneurs/the amount of takeover activity in the takeover market.

While equal treatment has limited explanatory power in explaining why bidders must make an offer for all classes of share, it clearly explains the requirement that such offers are 'comparable'. The notes to Rule 14 provide that in most instances a comparable offer for two or more classes of share will be determined by reference to the average of the 'middle market quotation' ratios for those classes of shares for the previous six months. The middle market quotation is the average of the best selling and buying prices for the shares at market close every day. So for example if the average middle market quotations for Class A shares is £10 a share and for Class B shares £20 a share, then the relevant ratio is 1:2. Accordingly, if the bidder wishes to offer £15 a share for Class A shares she will have to offer £30 a share for the Class B shares.

We saw in our analysis of class rights in Chapter 17 that difficulties arose when determining whether shares held by a shareholder who had been granted additional rights were a separate class of shares. In determining whether Rule 14 is applicable the Takeover Code is faced with a similar difficulty. This issue was raised in the recent Takeover Appeal Board case of *Eurotunnel Plc*, where certain shareholders who had been granted travel privileges on Eurotunnel claimed that such privileges rendered the shares held by them a separate class of shares requiring a separate and comparable offer that took into account the value of those privileges. The Panel Executive and the Hearing Committee rejected the claim; the shareholders appealed to the Appeal Board.

### **Takeover Appeal Board (2007/2)**

#### **Eurotunnel plc**

1. On appeal to the Takeover Appeal Board the central question is whether under a reorganisation of Eurotunnel Group the French Company, Groupe Eurotunnel SA ('GET SA'), should in making a general offer be required under the Takeover Code to treat shareholders, who hold certain travel privileges, differently from other shareholders and, in particular, whether a separate offer or offers should be made to them and, if so, on what terms.

#### ***The Matrix and History of the Dispute***

2. Eurotunnel has for some time been in financial difficulties. Negotiations with lenders with a view to reducing liabilities have taken place. Eurotunnel Group is undergoing a reorganisation with a view to reducing the Group's substantial debt burden. A key component of this reorganisation is the making of an offer to holders of units ('unit holders' or 'shareholders') in Eurotunnel by a newly established French company, GET SA. The offer is (insofar as it applies to Eurotunnel PLC) subject to the Code.

3. In outline the impact of the offer on existing travel privileges, under the existing scheme is as follows:

- (1) Unit holders who accept the offer in respect of all their units will no longer be entitled to receive the existing Eurotunnel travel privileges since they will no longer hold the necessary qualifying units.

- (2) Unit holders who decline to accept the offer in respect of at least the minimum number of qualifying units will continue to benefit from their existing travel privileges in accordance with the rules of the relevant scheme.

4. Holders of travel privileges submitted to the Executive of the Takeover Panel that since the offer is made on the same terms to shareholders entitled to certain travel privileges as it is to other shareholders in Eurotunnel, and as such does not take account of those travel privileges, it is in breach of the following provisions of the Code:

- (a) General Principle 1 – because the unit holders having travel privileges are required to ‘give up’ their travel privileges if they accept the offer, whereas other shareholders do not have to give anything up to do so, there is a breach of the principle in the first clause of General Principle 1 that all shareholders should be afforded equivalent treatment;
- (b) Rule 14.1 – because the shares held by the unit holders having travel privileges should be treated as a separate class (or classes) of equity share capital of Eurotunnel, Rule 14.1 has been breached since GET SA has not made a comparable offer for each such class;
- (c) Rule 14.2 – because the shares held by the unit holders having travel privileges should be treated as separate classes of equity share capital of Eurotunnel Rule 14.2 has been breached since GET SA has not made separate offers for each such class; and
- (d) the nature and purpose of the Code – because GET SA has not taken account of the value to the unit holders having travel privileges of their travel privileges in setting the terms of the offer there is a breach of the Code’s objective of ensuring that shareholders are treated fairly...

***The Primary Issue: Rule 14.1***

10. ... The Appeal Board noted that careful consideration was required to determine whether the travel privileges were ‘attached to’ or an integral part of the share rights. Both sides agreed that if that was not the case there could not be more than one class of equity share. The original prospectus stated, in respect of travel privileges ‘Individuals who continue to hold registered units acquired by them pursuant to the issue will be granted by EPLC the right’. This, *prima facie*, indicates that the travel privileges are a separate and distinct contract or scheme between the company and individuals not as a right attaching to the share but such contract/scheme having a condition that they must retain a shareholding in the company. This condition by the company provides an obligation to holders of the travel privileges to retain a minimum shareholding but there is no evidence that Eurotunnel intended to create a separate class of share through the scheme for travel privileges. No rights have been incorporated in the Articles of Association of the company and no specific linkages to separate class rights exist in the prospectus statements. The travel privileges were ancillary to the share offer and a separate contract. The appellants accepted that no separate class rights existed through the Company’s Articles of Association and contended that the Prospectus created such rights. Whilst the two Prospectuses carried separate chapters on the travel privileges there is no specific reference to creating a separate shareholder class. The appellants, when asked, could not identify any specific linkage. They could only rely on the shareholder retention requirement attached to the travel privileges and the comment that the travel privileges were offered in connection with the original share offers as an equivalent. As the Board could not accept that the travel privileges created a specific and separate class of share, Rule 14.1 of the Code does not apply.

11. The appellants strongly relied on observations by Scott J. (now Lord Scott of Foscote) in *Cumbrian Newspaper Group Limited v Cumberland & West Moreland Herald Newspaper & Printing Co. Ltd* [1987] Ch. Div. 1 made in the context of the words ‘rights attached to a class of shares’ in section 125 of the Companies Act 1985.

Undoubtedly there are some similarities between the *Cumbrian* case and the Eurotunnel case. On the other hand, there are also differences which were highlighted by the Hearings Committee. Most importantly, a different question arises in the present case, namely the contextual meaning of Rule 14.1 of the Code. The *Cumbrian* case does not assist on that point. Instead the Code must be interpreted in accordance with its purpose and underlying objective. The Appeal Board rejects the reliance on the *Cumbrian* case...

General Principle 1 of the Code

13. General Principle 1 provides as follows:

‘All holders of the securities of an offeree company of the same class must be afforded equivalent treatment...’

The Hearings Committee did not consider that this is a case where in order to achieve equivalence between those unit holders who have and those who do not have travel rights the former should receive some additional consideration beyond that offered to the latter. In agreement with the Hearings Committee the Appeal Board concludes that the requirement of equivalence does not extend to requiring compensation or making arrangements in the terms of an offer to deal with personal rights as opposed to those attached to the shares (and typically constituting the statutory contract) although there is no objection in principle to separate arrangements between individuals and the company to deal with such personal rights.

***The Nature and Purpose of the Code: Fairness***

14. Lastly, the appellants invoked the criterion of the Code that shareholders should be treated fairly: see Introduction to the Code, para 2 (a). In view of the conclusions already arrived at this argument collapses. It cannot afford a separate ground for relief in this case.

***Conclusion***

15. For these reasons, which are substantially the same as those of the Hearings Committee, the Appeal Board unanimously dismissed the appeal and confirmed the decision of the Hearings Committee.

The Appeal Board makes it clear that the question it must determine is what is the meaning of a class of shares for the purpose of Rule 14 of the Code. This determination is an autonomous determination unaffected by the meaning of a ‘class of shares’ for the purpose of the Companies Act 2006.<sup>143</sup> The Appeal Board finds that whether rights held by shareholders mean that they hold different class of shares depends on whether such rights are ‘attached to or are an integral part of the share rights’. The travel privileges are clearly not attached to the shares in the way that control rights or financial claims are attached to the shares; importantly such rights are not referred to in the Eurotunnel’s articles, which set out the rights attached to the shares. The difficult question is whether such privileges amount to an ‘integral part of the share rights’. In this regard the Appeal Board lays considerable store by the way in which these privileges were presented when the shares were issued. They find that they were not presented in the original prospectus as class rights nor were shareholders holding shares and having travel privileges presented as a separate class of shareholders. Accordingly, the Appeal Board finds that such rights do not create a separate class of shares to which Rule 14 is applicable; at best such privileges were personal rights. Furthermore, the Appeal Board rejects the claim that the Code’s commitment to equivalence and fairness require the bidder take account of those personal rights.

Some commentators have been highly critical of this finding. Consider in this regard the following abstract:

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<sup>143</sup> See pp 668–76.

**T.I. Ogowewo, 'The inequality of equality in takeovers' (2008) *Journal of International Banking Law and Regulation* 178**

The equivalence principle is part of the wider concept of fairness. Hence a consideration of General Principle 1, adopting a spirit over letter approach, must be with regard to the concept of fairness. If we approach General Principle 1 on its own the following analysis and conclusion will follow: General Principle 1 provides: 'All holders of the securities of an offeree company of the same class must be afforded equivalent treatment'. Accordingly, once the target shareholders with travel privileges were unable to demonstrate that their shares constituted a separate class, it followed that the identical offer to all the shareholders was not a breach of General Principle 1...

This conclusion becomes difficult to reach once we robustly apply the spirit of General Principle. The starting point is that '[t]he Code is designed principally to ensure that shareholders are treated fairly'. The [General Principles] 'are expressed in broad general terms and the Code does not define the precise extent of, or the limitations on, their application. They are applied in accordance with their spirit in order to achieve their underlying purpose.' General Principle 1 'constitutes an important part of the way in which the fair treatment objective stated in the Introduction [to the Code] is achieved'. Therefore, to the extent that some shareholders were going to surrender rights valuable to them (and *whose surrender* was valuable to the offeror) but were not in a position to negotiate any extraction of value for them because of collective action problems, the principle of fair treatment required that those shareholders ought to receive additional consideration beyond that offered to shareholders who surrendered nothing... A teleological interpretative approach to the Code that is faithful to its *raison d'être* would have produced a fairer result. It is not to the point that the equivalence principle has never been applied so as to require an offeror to 'make whole' offeree shareholders in respect of their personal situations (such as their tax positions) and contractual rights (such as director and/or employee, supplier, lender or customer rights) which they have with the offeree. Unlike those situations, the travel privileges were tied to shares (albeit fungible) through the share retention requirement and the offer's acceptance entailed their surrender. It is sophistry to argue that because the travel privileges are defeasible on a transfer of the shares, with the result that the shareholder cannot expect a higher price on account of vanished travel privileges, it perforce follows that such a shareholder has no reasonable expectation of receiving additional consideration when selling to a buyer seeking control of a company that is expected to see an increase in its revenue occasioned by a wholesale surrender of rights (in this case, unlimited lifetime rights to 'free' travel) vested in a multitude of shareholders. While the rights were of value only to the shareholders, their defeasance was of value to the bidder.

#### 4.4 Appropriate offers for convertibles

In addition to requiring comparable offers for all classes of shares, Rule 15 of the Code also requires that the bidder make an 'appropriate offer' for any securities that are convertible into a class of shares and that there is equality of treatment between the holders of the same class of such convertible securities.<sup>144</sup> A typical example of such a 'convertible' would be convertible debt that enables the debt holder to convert the debt into equity at a specified conversion ratio. Rule 15 also provides that the Rule applies to share options or subscription rights enabling the holder of shares to buy shares at a specified price. The requirement to

<sup>144</sup> Takeover Code, Rule 15(a) and Practice Statement No 24: Appropriate Offers and Proposals under Rule 15 (2009), para 2.13.

make an appropriate offer for such securities is applicable whether or not at the time of the takeover offer the options are exercisable or the conversion option available.<sup>145</sup> In any event, most bidders will view it as in their interests to make such an offer to prevent post-completion dilution.

What, however, amounts to an 'appropriate offer'? Invariably this is a much more complicated process than the determination of a comparable price as between different classes of shares. For this reason the Code requires that the target company's board obtain 'competent independent advice' on the offer made to the holders of convertibles and options and that this advice is made available to the security holders.<sup>146</sup> In addition the Executive has produced a practice statement on Rule 15 which provides guidance on how an 'appropriate offer' would be determined. Consider in this regard the following extracts.

**The Takeover Panel Practice Statement No 24: Appropriate Offers and Proposals Under Rule 15 (2009)**

...

**2. 'Appropriate' offer or proposal**

**(a) 'See through' value**

2.1 In order to be 'appropriate' in the terms of Rule 15(a), the Executive considers that an offer or proposal will normally need to be for no less than 'see through' value, i.e. the value of the Rule 15 securities by reference to the value of the voting equity offer.

2.2 The see through value of options, warrants and other rights to subscribe should be calculated net of any exercise price. This is illustrated by the following Example 1:

**Example 1**

Offeror A offers 100p for each ordinary share in offeree company B. Each offeree company B warrant entitles the holder to subscribe for one ordinary share in offeree company B at an exercise price of 10p. The see through value of each offeree company B warrant by reference to the value of the offer for the ordinary shares is therefore 90p.

2.3 Where the see through value of Rule 15 securities is positive, as in Example 1 above, an offer or proposal at no less than that value will normally be regarded by the Executive to be appropriate.

2.4 Where the see through value of Rule 15 securities is zero or negative, no Rule 15 offer or proposal will normally be required. This is illustrated by the following Example 2:

**Example 2**

Offeror C offers 10p for each ordinary share in offeree company D. Each offeree company D option entitles the holder to subscribe for one ordinary share in offeree company D at an exercise price of 30p. The see through value of each offeree company D option by reference to the value of the offer for the ordinary shares is therefore minus 20p. No Rule 15 offer or proposal in respect of such options would normally be required.

**(b) Convertible securities and other Rule 15 securities which are admitted to trading**

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<sup>145</sup> Takeover Code, Practice Statement No 24: Appropriate Offers and Proposals under Rule 15 (2009), para 1.1.

<sup>146</sup> Takeover Code, Rule 15(b).

2.5 Since convertible securities do not have an exercise price, their see through value will always be positive and an offer or proposal at no less than see through value will be required, even if that offer or proposal would be below the market price of the convertible securities.

2.6 Where the market price (if any) of any Rule 15 securities is higher than their see through value, for example where a convertible security is trading as a fixed income security, the Executive does not require a Rule 15 offer or proposal to be at market price or above. This is because, as indicated above, the purpose of Rule 15 is to safeguard the interests of holders of Rule 15 securities in their capacity as potential holders of the securities to which the voting equity offer relates. These points are illustrated by the following Example 3:

**Example 3**

Offeror E offers 200p for each ordinary share in offeree company F. Each offeree company F convertible bond entitles the holder to convert that bond into one ordinary share in offeree company F. The current market price of offeree company F convertible bonds is 220p. The see-through value of each offeree company F convertible bond by reference to the value of the offer for the ordinary shares is therefore 200p and a Rule 15 offer or proposal at no less than this value will normally be required. However, there is no requirement for the Rule 15 offer or proposal in respect of the convertible bonds to be at no less than the current market price of 220p.

**(c) No requirement to offer same specie as voting equity offer**

2.7 The Executive will regard a Rule 15 offer or proposal to be appropriate if made at no less than see through value. However, the Executive does not require any particular form of consideration to be offered to holders of Rule 15 securities. In particular, there is no requirement for holders of Rule 15 securities to be offered the same form of consideration as offered under the voting equity offer.

## 4.5 Equality and the form of consideration

A strict view of 'equality of treatment' would demand that where a bidder makes an offer, the consideration for which is an allotment of shares, but during the course of the offer he purchases shares outside of the offer – or even one share or any 'interest' in those shares – for cash, that the bidder would then have to make an identical or equivalent cash offer for the shares. While the Takeover Code does require that any such cash purchase is calibrated to ensure that the offer consideration is no less than the cash price paid for any shares<sup>147</sup> it does not require a cash alternative unless such aggregate cash purchases, *both during but outside of the offer and 12 months prior to the offer*, amount to 10% of the target company's issued voting shares.<sup>148</sup> If such cash purchases do not cross the 10% threshold then no cash alternative is required. However, Rule 11.1(c) also provides the Panel with a general discretion to require a cash offer in any circumstances without regard to the above rules where it is necessary to give effect to the equivalent treatment edict in General Principle 1. The Panel will not normally exercise this discretion unless the cash purchase in question was from a director or persons closely connected with the target or bidder. Again, this ensures, in

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<sup>147</sup> Takeover Code, Notes to Rule 6, Note 3 *No less favourable terms*.

<sup>148</sup> Takeover Code, Rule 11.1. See also note to Rule 6 *No less favourable terms*, noting that 'for the purpose of Rule 6.1, except where Rule 9 (mandatory offer) or Rule 11.1 (requirement for cash offer) applies, it will not be necessary to make a cash offer available even if interests in shares have been acquired for cash.'

particular, that the Takeover Panel can police and prevent target directors' support for the bid being purchased by preferential terms for the shares held by those directors.

If a cash alternative is required pursuant to this rule the offer shall be at the highest price paid for any share during the 12 months prior to the commencement of the offer, although Rule 11.4 provides the Panel with the discretion to reduce the offer below such 'highest price'.<sup>149</sup>

A similar set of rules apply where the offer is made in cash but certain shareholders, both prior to and during but outside of the offer, receive debt or equity securities for their shares. The rules in this regard, set out in Rule 11.2, provide that the bidder will 'normally' be required to offer a securities alternative if the aggregate purchase of shares during the offer and *three months prior to the offer* amount to 10% of the company's voting shares.<sup>150</sup> Where shares have been purchased for different amounts of securities the securities offer must be on the most favourable terms paid during that period.<sup>151</sup> The Code places less emphasis on shares purchased in exchange for securities outside of, or prior to, a cash offer, as compared to cash purchases outside of a securities offer, by only providing for a three-month rather than a 12-month look-back period. Nor does Rule 11.2 provide a general discretion to the Panel to provide for a securities offer as it does for a cash alternative pursuant to Rule 11.1(c). However, the notes to Rule 11.2 clarify that the Panel may look at less than 10% purchases and/or beyond the three-month period but stresses that they are only likely to do so where the purchases are from directors or persons closely connected with the target or the bidder.<sup>152</sup>

## 5 *Facilitating an informed and undistorted shareholder decision*

There are two prerequisites to making a decision about whether to accept or reject the bidder's offer based only on the merits of the offer: first, the shareholders must have available to them or be provided with the information that is necessary to make an informed decision; and, secondly, the nature and structure of the offer must not pressurize the shareholders to accept the offer for reasons that are *unconnected* to the offer price – that is, the decision as to whether to accept or reject the offer on its merits must be undistorted.

With regard to the information required to make an informed decision, the primary regulatory questions are: what is the nature of the information that needs to be provided; and how can we ensure that the preparation and presentation of this information does not distort the shareholder's decision-making process.

### 5.1 Information provision and shareholder choice

There are three primary categories of information which according to the Code must be provided to target shareholders: first, information about the offer itself; second, information

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<sup>149</sup> The Notes to Rule 11.4 provide the Panel with a list of factors to consider in determining whether or not to grant dispensation from the highest price, including the size and timing of the purchases as well as, importantly, whether such purchase were made from the directors.

<sup>150</sup> Where the 10% of shares has been purchased with a mixture of cash and securities the Code requires that the bidder consult with the Panel: Takeover Code, Note 5 to Rule 11.2.

<sup>151</sup> Takeover Code, Note 1 to Rule 11.2.

<sup>152</sup> Takeover Code, Note 2 to Rule 11.2.



about the target and bidder companies; and, third, information about the views of the target board on the offer.

Rule 30 provides that the offer document must be sent directly to the shareholders within 28 days of the announcement of the firm intention to make the offer. In addition the offer document must be made available for public inspection<sup>153</sup> and the bidder must announce through a Regulatory Information Service<sup>154</sup> that the offer has been published.<sup>155</sup> Rule 24 sets forth detailed regulation on the information that must be provided to target shareholders about the substance of the offer as well as the information to be provided to enable them to assess the offer. In relation to the substance of the offer, Rule 24.2(d) of Code sets out in detail what is to be included in an offer. This includes, among others:

- the name of the offeror and persons acting in concert with the offeror;
- the consideration offered for each class of share or security;
- the conditions to which the offer is subject;
- where the consideration is paid in securities, details of the rights attached to securities;
- details of any commitments from shareholders to sell their shares into the offer (known as 'irrevocable commitments');<sup>156</sup>
- details of any agreement to pay a break-fee/inducement fee.<sup>157</sup>

Note that in relation to the Code's requirements on the information to be contained in the offer document that any breach of these rules not only exposes the bidder to enforcement action by the Panel but, in addition, the 2006 Act provides that a criminal offence is committed by the bidder and any director or member of the bidder that 'caused the [offer] document'<sup>158</sup> to be published' if he knew that it did not, or was reckless as to whether, the offer document complied with the information rules.<sup>159</sup>

General Principle 2, Rule 19 *Information*, Rule 20 *Equality of Information to Shareholders and Persons with Information Rights*, and Rule 23 *The General Obligation as to Information* provide the core principles about information provision set out in the Code. These principles are as follows. First, shareholders should be provided in a timely manner with sufficient information to make an informed decision and no relevant information should be withheld from the shareholders.<sup>160</sup> Secondly, information must be made equally available to all shareholders

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<sup>153</sup> Takeover Code, Rules 30.1 and 26(p). The offer document must detail the information available for inspection and the place of inspection which must be in the City of London or another location agreed with the Panel (Rule 26).

<sup>154</sup> For a discussion of Regulatory Information Services (RISs) see Web Chapter B.

<sup>155</sup> Takeover Code, Rule 2.9.

<sup>156</sup> See Web Chapter A, B.II.7 below.

<sup>157</sup> See Web Chapter A, B.II.7 below.

<sup>158</sup> The term 'offer document' is defined in section 953 CA 2006 as the document giving effect to the Article 6.2 of the Takeover Directive which sets forth the minimum requirements of the offer document, which are included in Rule 24.2(d).

<sup>159</sup> Section 953 CA 2006. The offence is punishable by fine.

<sup>160</sup> Takeover Code, Rule 23.

or other parties who have information rights pursuant to the Companies Act 2006.<sup>161</sup> Thirdly, the information 'must be prepared to the highest standards of care and accuracy and the information given must be adequately and fairly presented'.<sup>162</sup>

## **Takeover Code**

### **Section I: Conduct During the Offer**

#### ***Rule 19. Information***

##### ***19.1 Standards of care***

Each document or advertisement published, or statement made, during the course of an offer must be prepared with the highest standards of care and accuracy and the information given must be adequately and fairly presented. This applies whether it is published by the party directly or by an adviser on its behalf.

#### ***Rule 20. Equality of Information***

##### ***20.1 Equality of information to shareholders and persons with information rights***

Information about parties to an offer must be made equally available to all offeree company shareholders and persons with information rights as nearly as possible at the same time and in the same manner.

#### ***Rule 23. The General Obligation as to Information***

Shareholders must be given sufficient information and advice to enable them to reach a properly informed decision as to the merits or demerits of an offer. Such information must be available to shareholders early enough to enable them to make a decision in good time. No relevant information should be withheld from them. The obligation of the offeror in these respects towards the shareholders of the offeree company is no less than an offeror's obligation towards its own shareholders.

In addition to these principled requirements about information production and provision, the Code has multiple specific information requirements. For example, to make a decision as to whether or not to accept the offer, the shareholders require information about the value of the target company to assess whether or not to accept the offer. The Code requires that the offer document contain detailed financial information about the target including financial statements; information about material changes to the company's financial and trading position since the last audited financial statements; and information on the company's significant accounting policies and changes to those policies.<sup>163</sup>

Where the offer is a cash offer, detailed financial information about the bidder is not needed or required. However, if the bidder company is paying for the target shares with securities rather than cash then the target shareholders need to be able to value those securities in order to assess the value of the offer. In such circumstances, therefore, the Code requires

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<sup>161</sup> Takeover Code, Rule 20. On such information rights see Chapter 3, p 100.

<sup>162</sup> Takeover Code, Rule 19. Accuracy, reliability and honesty in relation to information production may be supported by other legal provisions enforceable directly by the shareholders – see, for example, the circumstances in which duties can be owed directly to shareholders discussed in Chapter 9.

<sup>163</sup> Takeover Code, Rule 24(e).

that the detailed financial information required in relation to the target is also required in relation to the bidder.<sup>164</sup>

Where the consideration for the target shares is bidder securities, the future business plan of the bidder is clearly central to the shareholders' assessment of the offer. However, such plans are also relevant for target shareholders in a cash offer where the assessment of how valuable the target company is to the bidder given these plans is a relevant factor in the shareholders' assessment of whether the offer price is acceptable. Rule 24.1 of the Code requires that the offer document provides information about the bidder's intentions and strategic plans for the future operations of the business, as well as its 'long-term commercial justification for the proposed offer'.

Information about the bidder's future business plans is not only of central importance for shareholders, but also of importance to the employees of the target company who may be concerned about their job prospects in the future company. Rule 24.1 acknowledges these concerns by providing that the bidder must detail 'the likely repercussions [of the takeover] on employment and the locations of the offeree company's place of business'<sup>165</sup> and its intentions regarding the continued employment of target company employees and management.<sup>166</sup>

Of central importance to the target shareholders' assessment of the offer price is an assessment of the future profitability of the target company and, where the offer involves bidder securities, the bidder company. However, future financial predictions ('profit forecasts') are necessarily highly speculative and provide considerable scope for subjective judgment on the part of those preparing the projections. For example, such forecasts necessarily involve assumptions about the future state of the economy and the industry in which the company operates, as well as the company's future market share and its ability to control its costs. The Takeover Code is wary of such forecasts: it refers to the 'obvious hazards'<sup>167</sup> of such forecasts. The Code does not require the provision of such forecasts but does regulate their use. Rule 28.1 of the Code stresses that any profit forecasts 'published in connection with the offer' must be prepared with due care by the directors who bear 'sole responsibility' for the forecasts. To enable a transparent assessment of these profit forecasts Rule 28.2 of the Code requires: first, that the company disclose the assumptions which underpin the forecasts and highlight the 'uncertain factors that could materially disturb the ultimate achievement of the forecast';<sup>168</sup> and, second, in Note 2 to Rule 28.2, the Code sets out rules on the selection and drafting of profit forecast assumptions including, for example, that the assumptions should be specific not general and only relate to matters which materially<sup>169</sup> affect the forecast.

The Code also imposes on the company's advisors and accountants a verification role in relation to the forecasts. The Code requires that any profit forecast is reported on by the company's auditors as well as any financial advisor mentioned in the forecast.<sup>170</sup> This report

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<sup>164</sup> Takeover Code, Rule 24(a).

<sup>165</sup> Takeover Code, Rule 24.1(b).

<sup>166</sup> Takeover Code, Rule 24.1(e).

<sup>167</sup> Takeover Code, Rule 28.1.

<sup>168</sup> Takeover Code, Note 1(a) to Rule 28.2.

<sup>169</sup> Materiality is not defined by the Code.

<sup>170</sup> Takeover Code, Rule 28.3.

must be contained in any document or announcement making the forecast.<sup>171</sup> The auditors and the financial advisors are required to ensure that 'they satisfy themselves that the forecast has been prepared' with due care and consideration and that they do not 'allow' the use of unrealistic assumptions or the omission of assumptions that appear important without commenting on such unrealistic assumptions or omissions in its report on the forecast.<sup>172</sup>

Importantly, the Code is aware that forecasts may be made in documents that do not claim to be profit forecasts. Profit forecasts may be made without even referring to the word profit: for example, a statement on the company website to the effect that 'the board anticipates a 25% improvement in performance over the next year'. Rule 28.6 provides that the Code's regulation of profit forecasts applies to such statements:<sup>173</sup>

Whenever a form of words puts a floor under, or a ceiling on, the likely profits of a particular period or contains the data necessary to calculate an approximate figure for future profits, it will be treated by the Panel as a profit forecast which must be reported on.

## 5.2 The target board's opinion on the offer

Whilst the Code provides for the provision of a considerable body of financial and other information to the shareholders to assist them in making their decision as to whether or not to accept the offer, shareholders themselves, even financially literate institutional shareholders, are unlikely to have as good an understanding of the company, its business and future prospects as the management and board of directors of the target company. Executive directors' on-the-job experience and their understanding of the industry is not likely to be matched even by the most sophisticated of investors. Even non-executive directors will dedicate far more time to understanding the target company than most institutional shareholders and their fund managers. Furthermore, while shareholders are provided with much information about the target company, some information – such as the status of the target company's research and development projects – may be confidential and it cannot be provided to shareholders because if it were made publicly available it would assist the company's competitors.<sup>174</sup>

For these reasons the honest opinion of the target's board of directors as to whether, in their view, the offer is one that should be accepted or rejected is invaluable to shareholders. The Code provides for such an opinion in Rules 25 and 30.2, which require that the target board provide shareholders with its opinion on the offer within a 14-day period of the publication of the offer document.<sup>175</sup> Typically the target company's board will provide a unanimous opinion

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<sup>171</sup> Takeover Code, Rule 28.4.

<sup>172</sup> In this regard Note 1(c) to Rule 28.2 of the Takeover Code provides that 'the financial advisers and accountants obviously have substantial influence on the information about assumptions to be given in a circular; neither should allow an assumption to be published which appears to be unrealistic, or one to be omitted which appears to be important, without commenting appropriately in its report.'

<sup>173</sup> For an excellent consideration of Rule 28 and profit forecasting see T.I. Ogowewo, 'Profit Forecasts and the City Code' (2003) *Company Lawyer* 11.

<sup>174</sup> On the disclosure obligations for listed companies in relation to such information see Web Chapter B, Part A.

<sup>175</sup> Takeover Code, Rule 30.2. Pursuant to Rule 32.6 the board must also give its opinion on any revised offer.

on the proposed takeover. However, where there is no such unanimity the Code provides that the minority board opinion should also be published.<sup>176</sup>

The target board's opinion is designed not only to assist shareholders in making their decision but also to provide other company constituencies with the benefit of the board's opinion on how the takeover will affect their interests. Rule 25.1(b) provides that the board's opinion must also cover the effect of the implementation of the offer on 'all the company's interests, including, specifically, the effects of the bidder's strategic plan (as set out in the offer document)',<sup>177</sup> on target company employment and the location of the target company's business activities.<sup>178</sup> In addition, the board must append to its opinion on the offer the opinion of the employee representatives on the employment effects of the offer – 'provided such opinion is received in good time before the publication of that circular'.<sup>179</sup>

In addition to providing the board's opinion on the offer, Rule 25 also requires the publication of the 'substance' of the advice on the offer given by the target company's independent financial advisor, which the target is required to obtain pursuant to Rule 3.1.

Whilst the target board's honest view of the offer would be invaluable to the target shareholders, regulators and shareholders will have concerns about whether the stated view is the board's actual, honest view. Board conflicts run in both directions. Directors may have been offered attractive terms in the merged business going forward and as a result become too willing to recommend sale at an inadequate price. Alternatively, they may object to and recommend rejection of what they, in private, consider to be an excellent offer because they are concerned about losing their jobs, and the control benefits that their jobs bring, should the offer be successful. The Code responds clearly to the former concern in two ways. First, it provides that where a director has a conflict of interest he should not partake in the opinion<sup>180</sup> and the Code makes clear that where the director is connected to the bidder – for example, where the takeover is a **management buyout** – there is a presumption of conflict.<sup>181</sup> Secondly, the Code requires disclosure of the directors' interests in the securities of both bidder and target<sup>182</sup> as well as details of the directors' current service contracts including 'any provision for compensation payable upon early termination of the contract'.<sup>183</sup> The Code's

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<sup>176</sup> Takeover Code, Note 2 on Rule 25.1.

<sup>177</sup> Takeover Code, Rule 24.1.

<sup>178</sup> Note also that General Principle 2 provides that the target board 'must give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company's places of business'.

<sup>179</sup> Takeover Code, Rule 30.2(b). Pursuant to Rule 32.6(b) the opinion of the employee representative on a revised offer must be attached to the target board's opinion on the revised offer.

<sup>180</sup> Takeover Code, Note 3 to Rule 25.1.

<sup>181</sup> Takeover Code, Note 4 to Rule 25.1.

<sup>182</sup> Takeover Code, Rule 25.3.

<sup>183</sup> Takeover Code, Note 1(e) to Rule 25.4. See Chapter 8 pp 288–99 regarding Companies Act 2006 regulation of such payments.

only means of responding to the latter concern – board opinions distorted by the board's concern to protect their jobs – is by imposing clear obligations on the board to provide accurate and reliable information.<sup>184</sup> These Code obligations are supplemented by other common law and statutory remedies that may be available to the shareholders themselves, which we have considered elsewhere in the book.<sup>185</sup>

### 5.3 The structure of the offer and undistorted choice

A fully informed shareholder who considers the offer for the shares made by the bidder to be inadequate in value terms would not accept the offer if the only factors relevant to the decision were whether the offer was equal to or more than the shareholder's reservation price – the price at which she is willing to sell. Of course, as with any asset, the reservation price may be a function of factors other than cash-flow value. Many such factors may be benign personal factors with which regulation has no concern: the shareholder in question may be the founder of the company or a descendant of the founder and as a result there may be emotional barriers to sale. Putting such personal factors to one side, one of the objectives of takeover regulation is to ensure that the decision to sell or not to sell is based only upon the merits of / the value of the consideration being offered for the shares. One problem in this regard is that the structure of the offer itself can undermine this objective by creating incentives to accept the offer when, on the merits alone, the shareholder would not accept. To see this clearly, consider the following takeover structures. Note that neither *Example 1* nor *2* are compliant with the Takeover Code:<sup>186</sup>

#### Example 1

Bidder A, a renowned and well-respected **private equity** firm, makes an offer for Bob's Electronics Ltd at £20 a share, a 20% premium over the current market price. However, the offer is only open until Bidder A acquires 51% of the voting shares and is open on a first-come first-serve basis. The offer is open for a maximum of five days.

#### Example 2

Bidder B has a reputation in the market for using a controlling shareholding in companies to the detriment of minority shareholders.<sup>187</sup> Bidder B offers £20 per share, a 20% premium over the current market price, to acquire 100% of Bob's Electronics Plc's voting shares on a pro rata basis. The offer is open for one month. In shareholder A's view the shares are worth £25 a share. If he rejects the offer he does not have any legal right to require Bidder B to purchase his shares at a future date.

In *Example 1* the shareholders have only five days to make a decision. However, in reality they have less than this as the offer is on a first-come first-serve basis. This means that many

<sup>184</sup> Takeover Code, Rule 19.

<sup>185</sup> See Chapter 9 on duties owed to shareholders; see Web Chapter B on common law remedies for inaccurate and fraudulently prepared information.

<sup>186</sup> For a real world US example of a deal structure that may distort the shareholders' decision see the 'front-loaded two tier offer' used by the bidder in the *Unocal Corporation v Mesa Petroleum* 493 A 2d 946 (Del 1985) extracted and considered in Chapter 11, p 371.

<sup>187</sup> On private benefits of control see Chapter 16, pp 582–3.

shareholders may simply elect to accept the offer without considering carefully the information provided to them to determine whether or not it is a fair offer. If they wait too long they will miss out as other shareholders rush to sell. The structure of the offer prevents the shareholders making an informed decision about the offer even where such information is provided to them as part of the offer. Consider further if such an offer was not structured on a first-come first-serve basis but rather on a pro-rata basis, whereby if more shareholders accept the offer than the number of shares that the bidder has said he wishes to acquire the bidder will purchase an equal proportion of shares from each accepting shareholder. In such a situation the pressure to accept the offer is less acute: the shareholders have a full five days to make a decision. The question raised in such a circumstance is whether five days is sufficient to analyse the provided information and to obtain additional information and expert advice if required.

This structure in *Example 1* is prohibited by the Takeover Code. Partial offers, whether or not pro-rata, are prohibited without Panel approval, which is rarely granted if the offer will result in the bidder holding more than 30% of the target's voting shares.<sup>188</sup> Accordingly, an offer will always be for all of the shares and, therefore, there can be no 'first-come first-serve' condition imposed by the bidder. The Takeover Code also imposes mandatory minimum time periods for the bid.<sup>189</sup> The bid cannot as in *Example 1* be open for only five days. Pursuant to Rule 31.1, the offer 'must initially be open for at least 21 days following the date on which the offer document is published'.<sup>190</sup> The bidder could provide the shareholders with more than 21 days; however this is subject to the other rules regulating the timing of the bid considered further in section B.II.9 below. If the offer is revised then the Code provides that the shareholders must have at least an additional 14 days to consider the revised bid.<sup>191</sup>

The minimum 21-day period provides the shareholders with a significant period of time to digest the information and make a decision. There is no need to make a decision before the expiry of the offer period. In some jurisdictions one tool used to provide additional relief from any pressure to accept the offer is to provide the shareholders with 'withdrawal rights' – that is, rights to withdraw the shareholder's acceptance of the offer at any time prior to the offer closing. In the US, in relation to companies that are subject to the Securities and Exchange Act 1934, shareholders have withdrawal rights<sup>192</sup> at all times during the initial offer period, which must be for a minimum of 20 days.<sup>193</sup> This is not a tool that is deployed by the Takeover Code. Pursuant to the Code shareholders are not entitled to withdrawal rights at all times during which the offer is open; rather the shareholder benefits from withdrawal rights only 21 days after the first closing date if by that date the offer has not received sufficient

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<sup>188</sup> Takeover Code, Rule 36.

<sup>189</sup> On the bid timetable see further II.9 below.

<sup>190</sup> Article 7 of the EU's Thirteenth Company Law Directive provides that the period should be not less than two weeks and not more than 10 weeks, subject to rules on extensions.

<sup>191</sup> Takeover Code, Rule 32.1.

<sup>192</sup> Rule 14d-5 issued pursuant to the Securities and Exchange Act 1934. The withdrawal rights continue to apply if the offer is extended but not during any subsequent offering period once the actual offer has closed (pursuant to Rule 14d-11).

<sup>193</sup> Rule 14e-1 issued pursuant to the Securities and Exchange Act 1934.

acceptances to fulfil the acceptance condition<sup>194</sup> – at the earliest this means 42 days from the date of the posting of the offer document. These withdrawal rights do not, therefore, facilitate undistorted decision-making but rather enable withdrawal if the bid process is taking too long or the process is extended as a result of the arrival of another bidder.

In *Example 2*, above, the shareholders are not subject to the time pressures identified through *Example 1*. However, the shareholders may be subject to other structural pressures to sell. Shareholder A, who views the offer as inadequate, could elect not to sell his shares in the hope that other shareholders would share his view and that the offer at the current price would be rejected. If the board recommends rejection of the offer shareholder A may have some confidence that other shareholders will also elect to reject the offer. However, if the board recommends acceptance of the offer, shareholder A will be rightly concerned that a majority of the other shareholders will accept the offer. In such a situation, shareholder A may prefer to accept the offer to avoid being a minority shareholder exposed to expropriation by Bidder B. In the words of Vice Chancellor Strine of the Delaware Chancery Court, shareholder A may elect to sell into an inadequate offer for fear of the ‘800 pound’ controlling shareholder gorilla.<sup>195</sup> In this *Example 2*, although it appears to be the identity and reputation of the bidder that distorts shareholder A’s sale decision, the structure of the bid also plays a role: according to the terms of the offer the bidder has one opportunity to say ‘yes’ or ‘no’ and he must say ‘yes’ or ‘no’ before he knows what the other shareholders will actually do. The Takeover Code removes this structural distortion by providing that the shareholder can say ‘no’, by refusing to accept the offer, and then ‘yes’, if he discovers that his fellow shareholders do not share his view and that the bidder’s minimum acceptance condition<sup>196</sup> has been satisfied. The Code provides for this by requiring an extended offer period of at least 14 days during which the shareholder who had not accepted the offer can still accept the offer.<sup>197</sup> Furthermore, even if the shareholder continues to say ‘no’ during this extended offer period, the Companies Act 2006 provides additional ‘sell-out’ rights for shareholders in limited circumstances. These rights are discussed in B.II.5.5 below.

## 5.4 Theory and practice in shareholder decision-making

In relation to the provision of information about the target and bidder companies and facilitating an undistorted shareholder decision, the image of both the shareholder and his engagement with the takeover bid to which takeover regulation responds bears an increasingly limited relationship to actual shareholder activity and processes in the context of a real takeover bid. The implicit image upon which regulation is structured involves a shareholder who: needs to be assisted in gathering information – even though much, if not all, of the information is already publicly available; and who needs to be given time to think about and process this information before making a decision as to whether or not to accept the offer. In practice, however, a considerable portion of shareholders at the time a possible or firm offer is announced, or at the time the offer is made, will sell their shares in response to the rise in the share price, which takes account of both the announced offer price and the market’s assessment of any risk that the offer will not be completed. Many shareholders, institutional and retail alike, will not wait to receive and digest the information provided to them or take the time that the Takeover Code provides to them to assess the merits of the offer; rather they will exit their investment upon announcement of the offer, taking profits and transferring the risk that the bid may not be completed to investors who are willing to take

<sup>194</sup> Takeover Code, Rule 34.

<sup>195</sup> *Re Pure Resources Inc Shareholders Litigation* 808 A2d 421 (Del Ch 2002).

<sup>196</sup> See II.6 below on acceptance conditionality.

<sup>197</sup> Takeover Code, Rule 31.4.



those risks, known as merger arbitrageurs. These new shareholders are highly informed market participants who do not need much of the information required by the Takeover Code to be given to shareholders because they have already obtained and digested it.

**T. Tassell, 'The growing importance of arbitrage traders' *Financial Times* (27 October 2006)**

[Merger arbitrage **fund managers** or] arbs, as they have become known, play a game with asymmetric risks. The potential upside they target – the gap between what shareholders are willing to sell out at in a takeover and the actual offer price – is capped. But when deals collapse, the downside is steep as the target's share price slumps...

There is a strong economic rationale for the role of arbs... Most traditional shareholders are not specialists in assessing the complexities of antitrust law and the regulatory wrinkles that can lead to a deal falling through. Given that most of the price appreciation in a target happens after a deal is announced, it makes little sense for the traditional shareholder to hang on while the deal is signed off if they can reduce risk and sell out for a modest discount. This discount is the bread and butter of the arbs who can specialise in assessing the likelihood of a deal going through.

**L. Saigol and J. Politi, 'Arbitrageurs line up for M&A tightrope' *Financial Times* (24 September 2004)**

The growing influence of merger arbitrage was recently demonstrated during one of Europe's biggest hostile proposed deals: the takeover of Marks and Spencer, the UK high-street retail group, by Philip Green, the retail billionaire. By the time of Mr Green's third and final potential offer for M&S in July, about 20 per cent of the retail group's share register was made up of risk arbitrageurs, having started at almost zero...

M&S is not alone. A similar situation occurred in August last year during the two-way SFr4.35bn (\$3.45bn) battle for Centerpulse, the Swiss hip and knee joint maker. Before Centerpulse became the subject of twin bids from Zimmer, the US orthopaedics company, and its UK rival Smith & Nephew, its share register was made up of 24 per cent of retail investors and 76 per cent of institutional investors. By the end of the battle, which Zimmer won, more than 50 per cent of the share register consisted of merger arbs.<sup>198</sup>

Arguably the increasing presence of merger arbitrageurs in UK takeovers does cast some doubt over the need for some, or at least the importance, of the takeover process rules we have considered in this section, in particular information provision and the time to consider the bid. However, clear counter-arguments weigh against this view: first, not all shareholders will sell their shares into the market on announcement and such shareholders, whether retail or institutional, will benefit from the protection of these rules;<sup>199</sup> and, secondly, the clear imposition of rules of the game, particularly in relation to the nature of the bid and the time within which the bid can be accepted, provides all participants, however sophisticated, with certainty in relation to the bid process.

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<sup>198</sup> Kraft have launched a hostile bid for Cadburys Plc. In this regard the *Financial Times* reports speculation that at the end of the hostile bid merger arbitrageurs will own 25% of Cadbury's voting shares ('Kraft backed to Success in Cadbury Offer') *Financial Times* (11 November 2009).

<sup>199</sup> Note, however, that in Philip Green's bid for Marks and Spencer Plc in 2004, referred to in the above extract, a loyal retail investor shareholder constituency did not sell their shares in to the market and formed a vocal opposition to the bid: L. Saigol, 'Green walks from Marks and Spencer' *Financial Times* (14 July 2004).

## 5.5 Squeeze-out and buy-out rights in relation to non-accepting shareholders

Even where the vast majority of shareholders accept an offer, not all of them will do so. Some may, in contrast to most of their fellow shareholders, believe that the offer is undervalued, others may have non-cash flow value reasons for refusing to sell the shares. For many bidders the continuing presence of a 'stump' of minority shareholders represents a problem, or perhaps more accurately put, an annoyance. Such shareholders may if alone or in aggregate have the power to exercise rights provided to them in the Companies Act – for example, the right to call general meetings. Such shareholders could represent public relations problems for the company if they vocally oppose corporate action or indeed they could attempt to derivatively sue the directors. Most bidder companies would, following a successful bid, prefer to own 100% of the company and have the right to force the remaining shareholders to sell. However, to allow bidders, or the target companies they control following a successful bid, to force the sale of shareholder's shares represents a problem that, ostensibly at least,<sup>200</sup> tugs at some of the core underlying principles of a capitalist economy, namely that property owners can decide for themselves if and upon what terms they are willing to sell. This view of property rights is incommensurable with a forced-sale right. A regulatory solution that takes account of both of these positions must, therefore, balance the interests of bidders in taking complete control over the target that they have successfully bid with the property rights of shareholders who do not wish to sell. Such a compromise is forged in the UK, and in many other jurisdictions, around the threshold acceptance rate in the offer which operates as a proxy for the fairness of the terms of the offer<sup>201</sup> – the higher the acceptance rate, the more likely the offer is a fair offer and, implicitly, the less grave an injustice is done to unwilling shareholders.

For those shareholders who do not accept the offer within the course of the bid or during the extended offer period the Companies Act 2006 provides, in certain limited circumstances, the bidder with the right to *squeeze out* such shareholders – that is a right to acquire the remaining shares from shareholders that did not accept the offer. Note that in contrast to the Takeover Code rules the squeeze-out rules in the Companies Act apply to all companies. Section 979 of the Companies Act 2006 provides the bidder with a 'squeeze-out right' if the bidder acquires 90% of the shares or class of shares 'to which the offer<sup>202</sup> relates'.<sup>203</sup>

<sup>200</sup> A strong counter argument of course is that if shareholders purchase shares which are subject to such buy-out rules then in purchasing the shares they accept that their property rights as shareholders are subject to such buy-out rights.

<sup>201</sup> The Takeover Directive refers to the offer price as determined by the highest price paid during an applicable look-back period as an 'equitable price' (Article 5(4) Takeover Directive).

<sup>202</sup> Section 974 of the 2006 Act defines a takeover offer as an offer that is made to all the holders of the company's shares or applicable class of shares and is made on the same terms to each member or class member. Certain limited exceptions are made from the 'same terms requirements' where due to the securities laws of another jurisdiction the making of the offer to shareholders resident in that jurisdiction would be precluded or 'unduly onerous' for the bidder (section 976 Companies Act 2006). Such shareholders must, however, receive 'substantially equivalent' treatment (section 976 Companies Act 2006). The jurisdiction that typically creates difficulties in this regard is the United States. US Takeover Rules (known as the Williams Act and set out in the Securities Exchange Act 1934) are in certain instances applicable because some of the UK company's shareholders are resident in the US. The desire to avoid the application of these rules led to the use of so-called 'exclusionary offers' excluding shareholders resident in the US from receiving the offer and offer documentation. While US regulators have attempted to alleviate this problem through the introduction of certain exceptions from the application of US takeover rules (the 'Tier I' and 'Tier II' exceptions – see Rule 14d-1 issued pursuant to the Securities Exchange Act 1934) in practice due

Importantly, in calculating this 90% figure, any shares held by the bidder at the time the offer is made are not shares 'to which the offer relates'.<sup>204</sup> If a controlling shareholder with 80% of the target company shares makes a bid for the remaining 20% of shares, in order to exercise the squeeze-out right provided by section 979 he must acquire 90% of the 20%.

The Act provides a procedure to effect such a squeeze out including a time-limit within which notice of the bidder's intention to implement a squeeze out must be given, typically three months from the last date the offer can be accepted.<sup>205</sup> Once notice has been duly given the bidder is 'entitled and bound'<sup>206</sup> to purchase the shares.

The terms of the squeeze-out purchase will be the same as those in the original offer for the shares.<sup>207</sup> However, the Act does provide any shareholder who receives a squeeze-out notice with the right to apply to the court within six weeks of the notice for an order that the bidder is not entitled to purchase the shares or that such shares should be purchased on terms the court thinks fit.<sup>208</sup> The Act, however, constrains the courts discretion in this regard: it may not award consideration less than the original offer price and may only award more than the original offer price if *the shareholder* can demonstrate such original terms to be 'unfair'.<sup>209</sup> The

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to certain oddities in the application of these exceptions exclusionary offers are still very common. For an excellent review of these issues see S. Davidoff and B Carron, 'Getting U.S. Security Holders to the Party: The SEC's Cross-Border Release Five Years On' (2005) 26 *Journal of International Economic Law* 455.

<sup>203</sup> Any shares allotted after the date the offer is made are excluded from the calculation: section 979(5) CA 2006.

<sup>204</sup> Section 947(2) CA 2006. Note, however, that the shares 'to which the offer relates' includes any shares which the bidder has conditionally agreed to purchase before making the offer (section 979(6) and (7) Companies Act 2006) – this would include irrevocable commitments – in relation to which see further Web Chapter A, B.II.7 below.

<sup>205</sup> Section 980(2) CA 2006. This three-month period applies to all takeovers that are subject to the Takeover Code. In relation to offers that are not subject to the Takeover Code the time period is six months from the date the offer is made.

<sup>206</sup> Section 981(2) CA 2006.

<sup>207</sup> Section 981(2) CA 2006.

<sup>208</sup> Section 986 CA 2006.

<sup>209</sup> Section 986(4) Companies Act 2006. Note that to ensure that shareholders are not deterred from making these applications the Act provides explicitly that an award of costs may not be made against the shareholder. However, wary of abusive minority shareholders who are using the rights granted by the Act to unreasonably hold out for a better price, the Act allows the court to award costs against the shareholder who makes an application pursuant to section 986 if his behaviour in making the application is unreasonable or the application is deemed to be 'unreasonable, unnecessary or vexatious' (section 986(5) Companies Act 2006). On the term 'vexatious' see Hoffmann J's (as he then was) first instance judgment in *Re Britoil Plc* (unreported) where in considering an application that the offer price was unfair held that the application was vexatious and observed that "vexatious" is a term which...has been construed as having an objective meaning, that is to say, has not been *confined* to cases in which

courts, however, have taken a restrictive view of the meaning of 'unfair'. In this regard Hoffmann J in *Re Lifecare International Plc*<sup>210</sup> observed that:

It is well established that in an application such as this there is a heavy burden on the dissentient shareholder to satisfy the court that an offer which ex hypothesi has been accepted by over 90% of his fellow shareholders in the same class was in fact unfair. The court naturally starts with the assumption that the other shareholders are likely to know where their own interests lie as well as he.

However, the burden although heavy is not insuperable and the courts have acknowledged that flaws in the original bid process, for example questions about the independence of the 'independent financial advice', may be a ground for treating the offer terms as 'unfair'.<sup>211</sup>

In addition, for any shareholder who does not accept the offer during the extended offer period but subsequently changes his mind, section 983 of the Companies Act 2006 provides the right for any remaining shareholder to elect to be bought out by the bidder (a 'sell-out' right) where following the completion of the bid the bidder is the owner of 90% or more of the target's shares or class of shares: this 90% includes all shares owned by the bidder prior to the offer. Note that in practice the presence of the Code's Rule 31.4 extended offer period means that limited use is made of section 983. However, section 983 also applies to offers that are not subject to the requirements of the Takeover Code.

This sell-out right can only be exercised by any remaining shareholder within the latter of: a three-month period from the last date on which the offer can be accepted; or the date that is one month from the date the bidder gives the remaining shareholders notice, which he is required by the Act to do,<sup>212</sup> of their rights pursuant to section 983. Following the written communication by the shareholder to the bidder of the exercise of the sell-out right, the bidder is 'entitled and bound' to purchase the shares.<sup>213</sup> The terms of the required purchase will typically be the same as those offered in the original bid, although the Act does provide for alternative terms to be agreed between the parties.<sup>214</sup> Furthermore, section 986 of the Act does entitle the shareholder exercising this right with the right to apply to the court for an order that the purchase should be made on such alternative terms as the court thinks fit.<sup>215</sup>

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there was an intention on the part of the litigant to vex but where it is clear that there was no possible ground upon which the application could succeed'. The Court of Appeal in this case approved of Hoffmann J's observations in this regard (*Re Britoil Plc* [1990] BCC 70).

<sup>210</sup> [1990] BCLC 222.

<sup>211</sup> *Ibid*, Hoffmann J observing that 'if therefore the shareholder can demonstrate that the advice received by the board on the basis of which it made its recommendation was in some way flawed, he must thereby go some way towards discharging the burden on him.'

<sup>212</sup> Section 984(3) CA 2006.

<sup>213</sup> Section 985(2) CA 2006.

<sup>214</sup> Section 985(2) CA 2006.

<sup>215</sup> Section 986(3) CA 2006.

## 6 Offer conditionality

It is typical practice in commercial life to subject any offer or any agreement that is made to buy or sell a particular item to a range of conditions. If I offer to buy a car I can subject that offer, and a subsequent agreement, to conditions that the seller can choose to accept or reject. I could, for example, make the agreement conditional on obtaining finance from my bank to purchase the car or on the car passing its MOT. If the seller accepts these conditions I will not be obliged to purchase the car until the conditions are satisfied. *In theory*, an offer to purchase shares could be similarly conditioned preventing the effective acceptance of the offer until the conditions are satisfied.

Some conditions are clear objective conditions, the fulfilment of which has nothing to do with the offeror's efforts or subjective opinion – for example, whether the car passes its MOT is a function of whether it complies with the MOT criteria. The fulfilment of other conditions, however, can clearly be affected by the offeror's efforts and views. The fulfilment of the financing condition is clearly a function of the offeror's efforts to persuade a bank to lend him the money; a condition that 'the car is fast enough for the German autobahn' incorporates significant offeror subjective assessment. The problem with such conditions is that they enable the offeror to make an offer or agree a contract but *in effect* give him the sole power to determine whether the offer actually proceeds to an enforceable right of, in this example, the seller to sell the car for an agreed price. In the above examples the conditions empower the offeror to walk away claiming that he could not get finance although in fact he did not try, or that the car is not fast enough, although in his actual subjective view it would be. The Takeover Code is very wary of such conditions in takeover offers. The key Code provisions in this regard are set out below.

### Takeover Code

#### Section G. The Voluntary Offer and Its Terms

##### *Rule 10. The acceptance condition*

It must be a condition of any offer for voting equity share capital or for other transferable securities carrying voting rights which, if accepted in full, would result in the offeror holding shares carrying over 50% of the voting rights of the offeree company that the offer will not become or be declared unconditional as to acceptances unless the offeror has acquired or agreed to acquire (either pursuant to the offer or otherwise) shares carrying over 50% of the voting rights.

##### *Rule 13. Pre-conditions in firm offer announcements and offer conditions*

###### *13.1 Subjectivity*

An offer must not normally be subject to conditions or pre-conditions which depend solely on subjective judgements by the directors of the offeror or of the offeree company (as the case may be) or the fulfillment of which is in their hands. The Panel may be prepared to accept an element of subjectivity in certain circumstances where it is not practicable to specify all the factors on which satisfaction of a particular condition or pre-condition may depend, especially in cases involving official authorisations or regulatory clearances, the granting of which may be subject to additional material obligations for the offeror or the offeree company (as the case may be).

###### *13.2 The Competition Commission and the European Commission*

Neither a condition included pursuant to Rule 12.1(c)<sup>216</sup> nor a precondition included pursuant to Rule 13.3(a)<sup>217</sup> or (b)<sup>218</sup> will be subject to the provisions of Rules 13.1 or 13.4(a).

#### *13.4 Invoking conditions and pre-conditions*

(a) An offeror should not invoke any condition or pre-condition so as to cause the offer not to proceed, to lapse or to be withdrawn unless the circumstances which give rise to the right to invoke the condition or pre-condition are of material significance to the offeror in the context of the offer. The acceptance condition is not subject to this provision.

(b) Following the announcement of a firm intention to make an offer, an offeror should use all reasonable efforts to ensure the satisfaction of any conditions or pre-conditions to which the offer is subject.

#### *13.5 Invoking offeree protection conditions*

An offeree company should not invoke, or cause or permit the offeror to invoke, any condition to an offer unless the circumstances which give rise to the right to invoke the condition are of material significance to the shareholders in the offeree company in the context of the offer.

Rule 10 sets out that an offer must always be subject to a minimum acceptance condition. The fulfilment of this condition must result in the bidder holding at least 50% of the voting shares. If the bid fails to garner this level of acceptances then the bidder may not purchase any of the shares from shareholders that have accepted the offer. If the bid is unsuccessful the bidder may not launch another bid or trigger a mandatory bid (see B.II.9 below) for 12 months from the date the offer is withdrawn or lapses.<sup>219</sup>

Typically the imposed acceptance condition will be higher than a 50% threshold, for example acceptance of the offer by 90% of the shares not held by the bidder. The 90% threshold is common as it enables the bidder to 'squeeze out' the remaining shareholders pursuant to section 979 of the Companies Act 2006.<sup>220</sup> During the course of a bid, when the acceptance condition is fulfilled the bid is said to be 'unconditional as to acceptances'.

We see from Rule 13 that the Code has a strong bias against conditionality that has any element of offeror-subjectivity. The Code exercises tight control over conditionality not only in

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<sup>216</sup> Rule 12 provides that (1) it *must be a term of an offer* that where the offer falls within the statutory provisions for possible reference to the Competition Commission that the offer will lapse if a reference is made to the Competition Commission, and (2) it *must be a term of an offer* that where the offer would result in a concentration that falls within Council Directive 139/2004/EEC that the offer will lapse if the European Commission initiates proceedings or refers the matter to the Competition Commission.

<sup>217</sup> Rule 13.3(a) allows preconditions that there will be no referral to the Competition Commission or initiation of proceedings by the European Commission.

<sup>218</sup> Rule 13.3(b) allows preconditions that require permission to proceed where there is a referral to the Competition Commission or initiation of proceedings by the European Commission.

<sup>219</sup> Takeover Code, Rule 35.1.

<sup>220</sup> Discussed in Web Chapter A, B.II.5.5 above.

regard to imposition of offer conditionality by the bidder *but also* in relation to the invocation of accepted conditionality by either the bidder or the target. Importantly, simply because the bidder was allowed to include the condition does not mean it can be invoked to withdraw the offer. This is only possible when *in the Takeover Panel's view*<sup>221</sup> the right to invoke the condition is of 'material significance' to the bidder. Non-material unfulfilled conditions will not enable the bidder to walk away from the bid.

As we noted in the general discussion of conditions above, conditions, although objective, may depend for their fulfilment on the efforts of the bidder. Without bidder effort the condition will not be fulfilled. It is typical in takeover contexts for both bidder and target to contractually agree to use their 'best endeavours' or 'reasonable endeavours' to fulfil these conditions.<sup>222</sup> The Code also imposes the obligation on the bidder to 'use all reasonable efforts' to obtain fulfilment of the conditions.<sup>223</sup> Aside from regulatory approvals that are either exempted from the application of Rule 13.1 (as in the case of competition/anti-trust approvals) or viewed as objective and acceptable, there are two primary condition types: financing conditions and material adverse change conditions. Where the offer is a cash offer financing conditions are not allowed by the Code unless the cash is being raised by the issue of securities and such issue is subject to shareholder approval to authorize the allotment or to waive pre-emption rights, or approvals to obtain the listing of such securities.<sup>224</sup> Material adverse change clauses (referred to colloquially as MACs) aim to enable the bidder to withdraw from the bid if external events and circumstances 'materially' alter the condition of the target company. In the UK these conditions to the completion of the offer are typically drafted using the following standardized language:

[Save as publicly disclosed] no adverse change or deterioration having occurred in the business, assets, financial or trading position or profits or prospects or operational performance of any member of the [target company group of companies] which in any case is material in the context of the wider Group taken as a whole.<sup>225</sup>

Although such a clause is drafted objectively – it is *not* dependent on whether *in the bidder's view* there has been such an adverse change – the word 'adverse' is vague and a term likely to be subject to considerable variance in interpretation by bidder and target. Its meaning, however, is controlled by the Code and the Panel. As noted above, Rule 13.4 provides that a condition can only be invoked if it is of material significance to the bidder. Whether an adverse change is materially significant is, in effect, controlled by the Panel in each individual case. The Panel has not to date granted approval for any bidder to rely on a material adverse change clause. In WPP Group Plc's bid for Tempus Group Plc in 2001, WPP attempted to rely on such a clause following the terrorist atrocities in the United States on 11 September 2001. The Panel Executive rejected the bidder's attempt to rely on the material adverse

<sup>221</sup> Note 1 to Rule 13.5, although considering offeree conditionality makes clear that the Panel is the final arbiter of when accepted conditionality can be invoked.

<sup>222</sup> On the relationship between the target board's acceptance of such an obligation and the directors' duties see Chapter 10. For an example of the use of these terms ('all reasonable endeavours') see *John Crowther plc v Carpets international plc* [1990] BCLC 460.

<sup>223</sup> Takeover Code Rule 13.4(b).

<sup>224</sup> Takeover Code, Notes on Rules 13.1 and 13.3.

<sup>225</sup> Adapted from J. Rothschild, N. Azis, P. Corbiau, D. White and A. Reed (of McDermott, Will and Emory LLP), *Drafting Material Adverse Change Clauses* (<http://www.mwe.com/info/pubs/draftingmaterial.pdf>).

change clause as did the Takeover Panel on appeal.<sup>226</sup> The Takeover Panel observed that the bidder had failed to demonstrate material adverse significance in the target's long-term prospects 'by a considerable margin'. In holding that the condition could not be invoked the Panel's ruling appeared to affirm the applicability of an earlier Panel statement on a similar provision in the then Rule 2.7 of the earlier version of the Code to the effect that 'material significance' involved something akin to the legal frustration of a contract.<sup>227</sup> This view was corrected in a recent Panel Statement set out below.

## **The Takeover Panel, Practice Statement No 5**

### **Rule 13.4(A) – Invocation of Conditions**

The purpose of Rule 13.4(a) is to establish an overriding standard of materiality that must be satisfied before an offeror can rely on a condition for its benefit. The meaning of then Note 2 on Rule 13 (which became Rule 13.4(a)) was considered by the full Panel on appeal during the offer for Tempus Group plc by WPP Group plc, as reported in Panel Statement 2001/15. In that case, the condition in question which the offeror sought to rely on was a MAC condition. The Panel concluded that the necessary test of 'material significance' was not met and in its decision stated that:

'... meeting this test requires an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question, analogous... to something that would justify frustration of a legal contract.'

The Executive is aware that certain practitioners have interpreted Panel Statement 2001/15 to mean that an offeror would need to demonstrate legal frustration in order to be able to invoke a condition to its offer (other than the acceptance condition or any UK or EC competition condition). The Executive does not consider this interpretation to be correct.

In applying Rule 13.4(a) in the light of the Panel's decision set out in Panel Statement 2001/15, the Executive's practice is as follows:

- as set out in Rule 13.4(a), the appropriate test for the invocation of a condition is whether the relevant circumstances upon which the offeror is seeking to rely are of material significance to it in the context of the offer – which must be judged by reference to the facts of each case at the time the relevant circumstances arise;
- in the case of a MAC, or similar, condition, whether the above test is satisfied will depend on the offeror demonstrating that the relevant circumstances are of very considerable significance striking at the heart of the purpose of the transaction; and
- whilst the standard required to invoke such a condition is therefore a high one, the test does not require the offeror to demonstrate frustration in the legal sense.

We are not able here to provide a detailed account of the operation of the doctrine of frustration at common law. However, to provide a sense of the frustration benchmark with

<sup>226</sup> The appeal took place prior to the introduction of the Hearings Committee following the reforms to the Panel Structure to implement the Takeover Directive.

<sup>227</sup> *The Takeover Panel, Offer by WPP Group Plc for Tempus Group Plc* (2001/15) observing at para 16 'that meeting this test requires an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question, analogous, as the 1974/2 Panel Statement put it, to something that would justify frustration of a legal contract'.



which 'material significance' in the Takeover Code is compared, consider the following summary of the doctrine from Lord Simon in *National Carriers v Panalpina*.<sup>228</sup>

Frustration of a contract takes place when there supervenes an event (without default of either party and for which the contract makes no sufficient provision) which so significantly changes the nature (not merely the expense or onerousness) of the outstanding contractual rights and/or obligations from what the parties could reasonably have contemplated at the time of its execution that it would be unjust to hold them to the literal sense of its stipulations in the new circumstances; in such case the law declares both parties to be discharged from further performance.

It is very difficult to identify circumstances in which it would be possible for the bidder to rely on a material adverse change clause (to 'call a MAC'). It seems clear from the Takeover Panel's limited guidance and experience of dealing with MACs that external events, even extremely serious ones such as the terrorist attacks on September 11, 2001, are unlikely to provide a basis to claim that MAC condition is triggered. Even though such events may have significant short-term economy and industry effects they are unlikely to make a significant difference to the multiple-year future economic performance of the company. Perhaps, at the risk of speculating, the best example of a plausible MAC situation is the revelation to the bidder – post-bid – of material accounting errors or fraud of which the bidder had not been informed and which his **due diligence** could not reasonably have been expected to identify. It is, however, in the absence of more specific public guidance or actual examples of MAC events difficult to 'guesstimate' what, in percentage value terms, such a material accounting error would be.<sup>229</sup>

## 7 Deal protection

A bidder incurs significant financial costs in making a bid and is also, as a result of making the bid, exposed to potential reputational costs. The financial costs include: the costs of gathering information to identify the target company as an appropriate target for the bidder company; and the costs involved in negotiating and completing the bid, including, the costs of legal and financial advisors as well as the bidder's own **opportunity costs**. If the bid is unsuccessful the incurrence of these costs generates no return for the bidder. The potential reputational costs arise from the fact that a bidder who attempts but fails to consummate a takeover may find it more difficult to persuade the next target company to take its bid seriously; that is, bid failure may undermine a bidder's ability to do future deals. Given the incurrence of these costs the assessment of the risk of non-completion is a very important part of the bidder's assessment of whether or not to make a bid.

The risk of non-completion is particularly acute where the target board views the bid as unwanted and recommends to target shareholders the rejection of the bid. However, non-completion risk remains significant even where the board is receptive to the bid and recommends to the shareholders that they accept the bid. In particular, there are three types of non-completion risk: first, that the shareholders will reject the bid even in the absence of an alternative bid; second, that a legal obstacle, for example, the denial of competition authority approval, results in the required withdrawal of the bid; and, third, that another bidder outbids the original bidder. This latter risk may materialize as a result of an auction initiated by a target board of the company following the initial bidder's approach or through the unsolicited

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<sup>228</sup> [1981] AC 675. Approving of, together with Lords Hailsham and Lord Roskill, Lord Radcliffe's judgment in *Davis Contractors Ltd v Fareham UDC* [1956] AC 696. For a recent detailed judicial consideration of the doctrine of frustration see *Great Peace Shipping Ltd v Tsavliris Salvage (International) Ltd* [2002] All ER (D) 184 (Oct).

<sup>229</sup> For a useful comparative encounter with material adverse change clauses in the US see *Re IBP Inc Shareholders Litigation* 89 A2d 14; 2001 Del Ch.

entry of a third party bidder when the existence or possibility of the original bid is publicly announced.

In this section, we are concerned with friendly transactions where the target board is willing to recommend the proposed offer to shareholders. Even in such situations the bidder will be concerned about completion risks and the costs he will incur if such risks materialize. A rational bidder will ask how can he manage and/or be compensated for the risk of non-completion. There are three clear candidates in this respect. First, to contractually prevent or limit the ability of the target board to: withdraw its recommendation that the shareholders accept the bidder's offer (a no-withdrawal provision); solicit (a 'non-solicitation provision') or talk to and negotiate with other potential bidders (a 'no-talk' provision); or provide such bidders with non-public information. Secondly, where the failure to complete the offer arises from being out-bid by a competitor, the original bidder can be compensated by selling the shares of the target company he acquired pre-bid, at the offer price of the successful bidder. However, such a 'hedge' against non-completion only covers non-completion risk arising from competitive bids. Thirdly, the target could agree to provide a bidder with protection from non-completion risk by agreeing to provide it with what is known, by various terms, as an 'inducement fee'/'deal protection'/'break-fee' or a 'lock-up'.

## 7.1 No-withdrawal, non-solicitation, no-talk, and no-information provisions

In English law an agreement not to withdraw a recommendation, or to solicit, talk to or to provide information to other potential bidders for a specified period of time, is an enforceable agreement. However, the Code prevents no-information agreements as pursuant to Rule 20.2 the Code requires that any information given to one bidder 'must, on request, be given equally and promptly to another offeror or bona fide potential offeror, *even if that other offeror is less welcome*' (emphasis added). However, the Code does not prohibit no-withdrawal, non-solicitation or no-talk provisions.

The House of Lords considered the issue of the legality of such provisions in *Walford v Miles*<sup>230</sup> where the defendant agreed to terminate negotiations with other parties for a period of time (referred to in the case as a 'lock-out') but then subsequently sold the business to a third party. Lord Ackner, in the only reasoned judgment, held as follows:

### ***Walford v Miles* [1992] 1 All ER 453**

There is clearly no reason in English contract law why A, for good consideration, should not achieve an enforceable agreement whereby B agrees for a specified period of time not to negotiate with anyone except A in relation to the sale of his property. There are often good commercial reasons why A should desire to obtain such an agreement from B. B's property which A contemplates purchasing may be such as to require the expenditure of not inconsiderable time and money before A is in a position to assess what he is prepared to offer for its purchase or whether he wishes to make any offer at all. A may well consider that he is not prepared to run the risk of expending such time and money unless there is a worthwhile prospect, should he desire to make an offer to purchase, of B, not only then still owning the property, but of being prepared to consider his offer. A may wish to guard against the risk that, while he is investigating the wisdom of offering to buy B's property, B may have already disposed of it or, alternatively, may be so advanced in negotiations with a third party as to be unwilling or for all practical purposes unable to negotiate with A. But I stress that this is a negative agreement – B, by agreeing not to negotiate for this fixed period with a third party, locks himself out of such negotiations. He has in no legal sense locked himself *into* negotiations with A. What A has achieved is an exclusive opportunity, for

<sup>230</sup> [1992] 1 All ER 453.

a fixed period, to try and come to terms with B, an opportunity for which he has, unless he makes his agreement under seal, to give good consideration.<sup>231</sup>

As we considered in Chapter 10, where directors agree to restrict their future behaviour and discretion, a question is raised about the compliance of such agreements with the director's duties and a question about the enforceability of the provisions as a result of any non-compliance with the duties. We saw in Chapter 10 that, as the Court of Appeal in *Fulham Football Club Ltd v Cabra Estates plc* made clear, it was consistent with a director's duties for a director to fetter her future discretion. This position has now been codified in section 173(2) of the Companies Act 2006. This means that in principle<sup>232</sup> agreeing to no-withdrawal, no-talk or no-shop provisions may be duty compliant. Whether such agreed provisions are in fact inconsistent with the directors' obligation to act to promote the success of the company and use the requisite degree of care in so doing clearly depends on the facts of the case and obviously, in the context of section 172, the subjective views of the directors. For example, a no-talk provision for a long period of time in the context where there are several suitors would clearly raise concerns about compliance with section 172. As we observed in Chapter 10, where clear evidence of subjective belief is unavailable the courts will look to the plausibility of the reasons given for the decisions.<sup>233</sup> In a multiple suitor context the reasons given by the directors for agreeing to such provisions may strain plausibility. However, contexts in which it is difficult to sell the company or where a particular suitor is viewed by the directors as a key strategic partner would indeed render no-talk provisions duty compliant.

If agreeing to a no-talk, non-solicitation or no-withdrawal provision amounts to a breach of duty the provision itself may remain enforceable. The key question for the court in this context is whether the board would have apparent authority to agree to the term even though in breach of duty. If the bidder is aware that it amounts to a breach of duty then the bidder cannot rely on the apparent authority doctrine;<sup>234</sup> if they are deemed not aware of this fact then the provision will remain enforceable.<sup>235</sup>

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<sup>231</sup> See also *Dawson International plc v Coats Paton plc* [1989] BCLC 233 where Lord Cullen in the Scottish Outer House rejected an argument that a company does not have the capacity to enter into an agreement not to encourage, or cooperate, with other bidders.

<sup>232</sup> This case does not explicitly address these provisions; however, this view follows clearly from the case's discussion of *John Crowther Group plc v Carpets International plc* [1990] BCLC 460.

<sup>233</sup> See, for example, *Regentcrest v Cohen* [2001] 2 BCLC 80 extracted at 309–12.

<sup>234</sup> On apparent authority see Chapter 4.

<sup>235</sup> *Criterion Properties plc v Stratford UK Properties LLC* [2004] UKHL 28, Lord Scott: 'if a person dealing with an agent knows that the agent does not have actual authority to conclude the contract or transaction in question, the person cannot rely on apparent authority. Apparent authority can only be relied upon by someone who does not know that the agent has no actual authority. And if a person dealing with an agent knows or has reason to believe that the contract or transaction is contrary to the commercial interests of the agent's principal, it is likely to be very difficult for the person to assert with any credibility that he believed the agent did have actual authority. Lack of such a belief would be fatal to a claim that the agent had apparent authority.'

## 7.2 Inducement fees

As noted above there are several terms used to describe the fee that the target agrees to pay the bidder on the occurrence of specified events such as the withdrawal of the target board's recommendation of the offer. The choice of term is invariably connected to the size of the fee and/or is indicative of the users' view of this mechanism. The term 'inducement fee' is the term used by Takeover Code. As the term suggests this is a fee that is agreed to be paid to the bidder to induce it to make the offer even though there are identifiable risks that the offer will not be successful. *In theory*, the fee may be structured as the parties agree as regards the size of the fee, the trigger events which render the fee payable and the form of consideration. For example, it could involve a cash payment, an option to purchase shares at a specified price, or the purchase of a particular asset at a pre-agreed price.<sup>236</sup> Typically the inducement fee will be a percentage of the value (market capitalization) of the company as determined by reference to the bid value. As we shall see below, the Code places restrictions on the size of the inducement fee. It is important to stress that although agreeing to an inducement fee may result in a considerable transfer in value in absolute terms to an unsuccessful bidder, it may be viewed as beneficial to the target company and its shareholders because it either enables a bid to proceed where otherwise there may be no willing bidder, or it induces other potential participants to join a bidding process which may ultimately result in a higher price for the shareholders. In the United States such fees have long been commonplace; however, they did not become a standard part of a takeover deal in the UK until the late 1990s. As of 2002 89% of takeover bids for companies valued above £250 million contained an inducement fee.<sup>237</sup>

The primary problem with an inducement fee is that it may be used as a defensive technique to 'lock-up' the deal or 'lock out' other potential bidders. If, for example, the target and bidder agree to an inducement fee amounting to 10% of the company's value, this reduces the value of the company being purchased by 10% from another bidder's perspective. If Bidder A bids £10 a share for all of the one hundred million share in a company and the target agrees to a 10% inducement fee, Bidder B will be required to bid more than £10 a share for what is from Bidder B's perspective a £900 million company. As this example shows, the 'inducement fee' may render any alternative bids 'uneconomic'. As we shall see in B.IV below, the Takeover Code imposes an effective ban on defensive action<sup>238</sup> taken by the target company board to prevent the shareholders being able to decide on the merits of a bid. By in effect preventing Bidder B from making an offer arguably such an inducement fee falls foul of that prohibition. The problem for a regulator of course is to identify when a fee amounts to a legitimate inducement or an illegitimate 'lock-up'.

Before we consider the Code's regulation of inducement fees let us first consider the compatibility of inducement fees with other relevant aspects of UK company law: directors' duties and financial assistance regulation. With regard to directors' duties it is clear that if a director considers that the inducement fee is required to facilitate a bid or a competitive auction process then he complies with his duty to promote the success of the company set out in section 172 of the Companies Act 2006. While clearly it may be difficult to parse a director's motivation for actually agreeing to the inducement fee, in practice the availability of

<sup>236</sup> With regard to the different types of inducement fee/break-fee arrangement the facts of the following two Delaware cases make for interesting reading. *Revlon Inc v MacAndrews & Forbes Holding Inc* 506 A.2d 173 (Del.1986); *Paramount Communications Inc. v QVC Network Inc.* 637 A.2d 34 (Del. 1994)

<sup>237</sup> Herbert Smith Briefing, *Break-Fees* (January 2004). See also 'Outlook: Inducement Fees' (14 May 1999) *Independent* observing that 'largely unnoticed, a new practice has crept into the British takeover scene – that of offering "inducement fees"'.

<sup>238</sup> Takeover Code, Rule 21. Such action is allowed if the board obtains contemporaneous shareholder approval for such action. Note that the regulation of inducement fees in the Code, addressed below, is set out in Rule 21 (Rule 21.2).

such positive rationales means that inducement fees that comply with both market practice and the Takeover Code will be 'unimpeachable' from the viewpoint of compliance with directors' duties. Financial assistance rules create more difficulties that remain only partially explored by the existing cases.<sup>239</sup>

In order to fall within the financial assistance prohibition for public companies set out in section 678 of the Companies Act 2006, the assistance must: (1) amount to 'financial assistance' given to someone purchasing or proposing to purchase shares; (2) fall within the financial assistance categories set out in section 677; and (3) be given for the purpose of acquiring the shares. The term 'financial assistance', following *Charterhouse v Tempest Diesels*<sup>240</sup> and *Chaston v SWP Group Plc*<sup>241</sup> must be interpreted as a commercial term. Clearly, offering to make a contingent payment if a bidder's bid is unsuccessful provides a financial inducement to proceed with the bid and the ultimate purchase of the shares. Without it the purchase may never have come to fruition. It is, therefore, from a commercial perspective 'financial assistance'. However, in this author's view it is not prohibited financial assistance. There are two reasons for this view. First, the inducement fee does not fall within any of the categories in section 677. It does not fall within the categories set out in section 677(1)(a)–(c): it is neither a gift; nor a guarantee, security or indemnity;<sup>242</sup> nor a release or a waiver; nor a loan or novation. Nor is an inducement fee *likely* to fall within the catch-all category set out in section 677(1)(d): financial assistance providing a material reduction in net-assets. Inducement fees in the UK do not typically exceed 1% of company value.<sup>243</sup> Arguably 1% is not material in value terms and it is certainly considerably lower than the 20% of net-assets figure that was found to be material in *Chaston v SWP*. Nevertheless, it is clearly plausible that low percentage (in company value terms), but high in absolute terms, inducement fees may potentially be viewed by courts as 'material'. However, whilst arguably

<sup>239</sup> Before reading further, the reader is advised to review section V of Chapter 17 on financial assistance, knowledge of which is assumed in the analysis set out below.

<sup>240</sup> [1986] BCLC 1.

<sup>241</sup> [2003] 1 BCLC 675.

<sup>242</sup> One could argue that an inducement fee amounts to an indemnity as it is designed in part to compensate the failed bidder for his expenditure incurred in bidding for the shares. In *Fanti Padre Island (No 2)* [1991] 2 AC 1, Lord Goff held that 'a promise of indemnity is simply a promise to hold the indemnified person harmless against a specified loss or expense'. To hold a person harmless involves ensuring that any such loss or expenditure is covered by the other person who grants the indemnity. However, while a break-fee does compensate the bidder for his actual expenditure and other losses such as opportunity costs and reputational damage, the fee is not, typically, variable according to a calculation of such losses. The bidders are not 'held harmless' from such losses. Accordingly, break-fees should not be understood as indemnities. In this regard see the minutes of the 24 March 2009 meeting of the City of London Law Society City of London sub-committee observing that 'where a listed company has agreed to indemnify a third party for its costs in circumstances where that third party is proposing to acquire assets from the listed company, that transaction should properly be characterized as an indemnity and not a break-fee arrangement' (<http://www.citysolicitors.org.uk/FileServer.aspx?oID=586&lID=0>).

<sup>243</sup> The Takeover Code (Rule 21.2) imposes a 'normal' 1% limitation discussed below. The Code refers to such a 1% or less inducement fee as '*de minimis*'. Note however that the Code explicitly states that its view on inducement fees does not effect the legality of such arrangements pursuant to the financial assistance regime set out in the Companies Act 2006 – Note 2 to Rule 21.2.

'material' in value terms, inducement fees are very unlikely to reduce a company's net-assets as set out in the company's accounts<sup>244</sup> *at all*. The reason for this is that, pursuant to the applicable accounting standards,<sup>245</sup> in most instances the probability that the inducement fee will be paid out is less than 50%, and where the probability of payment is less than 50% the inducement fee for the target company is a contingent liability that is not taken directly into account as a liability.<sup>246</sup> If the probability of payment is more than 50% then it will be taken into account as a provision<sup>247</sup> and the question of whether the liability entry<sup>248</sup> is material for the purposes of section 677(1)(d) then arises. If a 1% fee given its absolute size would be deemed material but at the time the inducement fee was granted the probability of payment was less than 50% then there is no financial assistance at the time of granting the fee.<sup>249</sup> However, what if due to the course of events the contingent liability is realized? Is there financial assistance at that point? The answer is again no, because at the time it results in a material reduction in net assets the payment is not made in relation to a proposed or actual acquisition – a third party has purchased the target – it is made to fulfil a contractual obligation that did not amount to financial assistance at the time it was entered into. Finally, there is an additional reason why, in this author's view, even if the particular inducement fee falls within section 677(1)(d), it does not amount to financial assistance. This reason is the same reason why *Chaston* is incorrectly decided as explained in Chapter 17: the break fee does not financially assist *the purchase* of the shares but is given *in connection with* the purchase of the shares. Assistance given in connection with the purchase does not – as argued in Chapter 17 – fall within the prohibition.

According to the above analysis, English company law imposes very limited restrictions on the parties to a takeover bid agreeing an inducement fee. In contrast, the Takeover Code imposes clear and strict regulation of inducement fees.

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<sup>244</sup> The net-asset figure is calculated by reference to the company's accounts: section 677(3).

<sup>245</sup> Financial Reporting Standard 12, *Provisions, Contingent Liabilities and Contingent Assets* (Accounting Standards Board, 1998); International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets* (IASB).

<sup>246</sup> Contingent liabilities are merely noted in the notes to the accounts *ibid*.

<sup>247</sup> Section 677(3) CA 2006 states explicitly that provisions will be taken into account. According to FRS 12, a provision, which is defined as 'a liability that is of uncertain timing and amount', must be recognised when: a company has a 'present obligation' arising from a 'past event'; it is more likely than not that 'economic benefits' must be transferred by the company to settle the obligation; and where a 'reliable estimate' of the amount of the obligation can be made. (Financial Reporting Standard, *Provisions, Contingent Liabilities and Contingent Assets* (Accounting Standards Board, 1998), 3. Para 2).

<sup>248</sup> Provisioning will not be for the full amount of the inducement fee of 1% but will be reduced to take account of the probability of payment. The amount of provision must be the best estimate of the amount that will be paid, which FRS 12 defines as the 'amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time' (para 37).

<sup>249</sup> Note, however, that if there are multiple bidders and each of those bidders receives an inducement fee then the probability of one of those inducement fees being triggered is 100% and, therefore, it is likely that one or more of those inducement fees has a probability of trigger of greater than 50%.

## Takeover Code

### *Rule 21.2. Inducement Fees*

In all cases where an inducement fee is proposed, certain safeguards must be observed. In particular, an inducement fee<sup>250</sup> must be *de minimis* (normally no more than 1% of the value of the offeree company calculated by reference to the offer price) and the offeree company board and its financial adviser must confirm to the Panel in writing that, inter alia, they each believe the fee to be in the best interests of shareholders. Any inducement fee arrangement must be fully disclosed in the announcement made under Rule 2.5 and in the offer document. Relevant documents must be put on display in accordance with Rule 26.<sup>251</sup>

The Panel should be consulted at the earliest opportunity in all cases where an inducement fee or any similar arrangement is proposed.

Pursuant to Rule 21.2 the Panel must always be informed of the intention to agree an inducement fee. The Panel's control over inducement fees is further enhanced by a typical Panel requirement to include the following provision in any inducement fee agreement:

Nothing in this agreement shall oblige [the offeree company] to pay any amount which the Panel determines would not be permitted by Rule 21.2 of the Takeover Code.

Rule 21.2 provides that inducement fees will not normally be greater than 1% of the value of the company.<sup>252</sup> The Panel's Practice Statement on Inducement Fees observes that the primary rationale for the 1% limit is 'to prevent the possible payment of an inducement fee from frustrating a competing bid'.<sup>253</sup>

In addition to the 1% limitation, the Panel also imposes procedural safeguards on the target board and their advisors requiring separate confirmations to the Panel of certain facts, and the provision of information on the inducement fee negotiation process.

### **Takeover Panel, Practice Statement No 23: Rule 21.2 – Inducement Fee Agreements and other Agreements between an Offeror and the Offeree Company (2008)**

#### **4. Confirmations to the Executive**

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<sup>250</sup> The term 'inducement fee' is defined by Note 1 to Rule 21.2 to refer to a cash payment payable on the occurrence of certain events 'which have the effect of preventing the offer proceeding'. Other break-fee arrangements are not therefore, 'inducement fees' for the purposes of the Code, however, this is only of semantic importance as Note 1 clarifies that Rule 21.2 also applies to any other such arrangements 'which have a similar or comparable financial or economic effect'.

<sup>251</sup> Rule 26 provides for the inspection of specified documentation.

<sup>252</sup> Note that a break-fee which exceeds 1% of company value (calculated by reference to the offer price) is treated by the Listing Rules as a Class 1 transaction, requiring the approval of the shareholders in general meeting (LR 10.2.7).

<sup>253</sup> Takeover Panel; Practice Statement No 23: Rule 21.2 – Inducement Fee Agreements and other Agreements between an Offeror and the Offeree Company (2008). As noted above Rule 21.2 is part of Rule 21: *Restrictions on Frustrating Action*.

4.1 A further safeguard which must be observed prior to agreeing to pay an inducement fee is that the offeree company board and its financial adviser must provide certain written confirmations to the Panel.

4.2 Each of the offeree company board and its financial adviser must give separate written confirmations, or a single confirmation, signed by, or on behalf of, both the offeree company board and the financial adviser. A letter from the financial adviser on behalf of the board will not be acceptable.

4.3 The written confirmations should normally address the following points:

- (a) confirmation that the inducement fee was agreed as a result of arms' length commercial negotiations;
- (b) an explanation of the circumstances in which the inducement fee will become payable and the basis on which such circumstances were considered appropriate;
- (c) any relevant information concerning possible competing offerors, for example, the status of any discussions, the possible offer terms, any pre-conditions to the making of an offer and the timing of any such offer;
- (d) confirmation that there are no side agreements or understandings in relation to the inducement fee that have not been fully disclosed; and
- (e) confirmation that, in the opinion of the offeree company board and its financial adviser, the agreement to pay the inducement fee is in the best interests of offeree company shareholders.

### 7.3 Matching rights

The nature and use of inducement fees continues to evolve within the parameters of the above regulation. One noteworthy recent development in this regard is the use of 'matching rights', which involve the target company agreeing to: inform the bidder upon being informed of a third party's intention to make a higher offer; to give, within a specified time period, the bidder an opportunity to match or better that third-party offer; and to pay an inducement fee if the board fails to recommend the original bidder's matched offer. These matching rights are viewed in the market place as being effective ways of deterring competing bids.<sup>254</sup> The later bidder knows that these rights tip the balance firmly in favour of the original bidder, as a determined original bidder is highly likely to retain the board recommendation if the original bidder merely matches the other bidder's bid. Such rights are, however, subject to the Takeover Panel's regulation of competitive bids discussed in B.II.8 below.

### 7.4 Irrevocable undertakings

One final aspect of UK takeover practice that also provides some limited comfort for bidders that they will be able to consummate a bid is the use of 'irrevocable undertakings', many of which are, typically, revocable! An irrevocable undertaking is an undertaking given by a shareholder that she will tender her shares into the offer made by the bidder. It enables the bidder to feel comfortable that at the offered price a critical mass of shareholders will accept the offer. There are two main types of irrevocable undertakings: 'hard irrevocables' and 'soft irrevocables'. Hard irrevocables are typically given by the directors of the target companies and are in fact irrevocable undertakings to sell the shares regardless of whether a higher bid is made for the shares. Other shareholders, including institutional shareholders, will at best give 'soft irrevocables' which involve a commitment to accept the offer provided no other bidder offers a higher price.

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<sup>254</sup> See Norton Rose, *Deal Protection in UK for Public Company M&A* (July 2008) observing that 'there is a strong argument that offering matching rights may deter other bidders'.



## 8 *Regulating multiple bids*

### 8.1 **Facilitating an orderly and conclusive competition**

As is clear from the above discussion on deal protection, it is commonplace for two or more companies to make bids for a target company. A competitive bid process is clearly very favourable to target shareholders as it drives up the price that the shareholders will receive for their shares. Enabling the competitive process to 'play itself out' is important from a shareholder value perspective. However, the problem that arises from competing bids is that the process can go on *ad infinitum* unless a definitive set of auction rules are imposed. This problem is exacerbated by the use of matching rights that create an obstacle to the company itself imposing a final 'sealed bids' round of bids, as if the bidder benefiting from matching rights is outbid the target is contractually obliged to let that bidder match the higher bid. Importantly, however, the Code and the Panel impose strict control over a competitive process to ensure that it reaches closure relatively quickly.

#### **Takeover Code**

##### ***Rule 32.5. Competitive Situations***

If a competitive situation continues to exist in the later stages of the offer period, the Panel will normally require revised offers to be announced in accordance with an auction procedure, the terms of which will be determined by the Panel. That procedure will normally require final revisions to competing offers to be announced by the 46th day following the publication of the competing offer document but enable an offeror to revise its offer within a set period in response to any revision announced by a competing offeror on or after the 46th day.<sup>255</sup> The procedure will not normally require any revised offer document to be sent to offeree company shareholders and persons with information rights before the expiry of a set period after the last revision to either offer is announced. The Panel will consider applying any alternative procedure which is agreed between competing offerors and the board of the offeree company.

If this open auction implemented pursuant to rule 32.5 does not result in the clear resolution of the competitive situation the Panel may impose a sealed-bid process to obtain the final offers from the competitors. As an example of a sealed-bid procedure, consider the following Panel Statement in the case of multiple bids for Enodis Plc.

#### **Offers By MTW County Limited ('Manitowoc') And FNI Limited ('ITW') For Enodis Plc ('Enodis') (2008/26)**

On 14 April 2008, Manitowoc announced a recommended cash offer of 258 pence per share for Enodis, with Enodis shareholders also being entitled to receive a dividend of 2 pence per Enodis share... On 8 May, ITW announced a recommended cash offer for Enodis of 280 pence per Enodis share, with Enodis shareholders also being entitled to receive a dividend of 2 pence per Enodis share... On 19 May, Manitowoc announced a revised offer of 294 pence per Enodis share, with Enodis shareholders being entitled to receive a dividend of 2 pence per Enodis share.

On 23 June, the dividend of 2 pence per Enodis share was paid to Enodis shareholders who were on the share register on the record date... On the basis that neither offeror has declared that the offer which it has announced to be final, such that either offer may be increased or otherwise revised, a competitive situation continues to exist for the purposes of Rule 32.5 of the Takeover Code ('the Code').

<sup>255</sup> On the importance of the 46th day see Web Chapter A, B.II.9 *The offer timetable* below.

In order to provide an orderly framework for the resolution of this competitive situation, and in accordance with Rule 32.5 of the Code, the Panel Executive has, after discussions with the parties, established an auction procedure which will take place if a competitive situation continues to exist as at 4.30 p.m. (London time) on 27 June. If such is the case, neither of the offerors may thereafter announce a revised offer, or introduce any new alternative offer, for Enodis other than in accordance with the auction procedure summarised below (unless, under the normal provisions of the Code, a third party announces a firm intention to make an offer for Enodis).

There shall only be one round in the auction procedure. This round will take place after the close of trading hours on the London Stock Exchange on 30 June. During the round, each offeror will be able to lodge an increased bid with the Panel Executive. Any increased bid lodged by either offeror must be at a fixed price in cash and must be not less than 5 pence in cash higher than the price of the highest cash offer announced by either offeror prior to the commencement of the auction procedure (or, if prior to the commencement of the auction procedure the cash offers announced by both offerors are at the same price, not less than 5 pence in cash higher than the price of those offers). Any increased bid lodged by ITW may only be at an odd numbered price; any increased bid lodged by Manitowoc may only be at an even numbered price...

Following its conclusion, the Panel Executive shall announce the result of the auction procedure.

## 8.2 Director's duties in competitive situations

Where directors of target companies find themselves in situations where several bidders are competing to purchase the company, or where directors of the target contemplate proactively auctioning the company, two questions arise. First, are directors under a positive duty to take all steps to maximize the value of the company? Second, are they under a positive duty to recommend the highest value bid to the target shareholders?

Pursuant to section 172 of the Companies Act 2006, directors are under a duty to do what they consider will promote the success of the company for the benefit of the members. They must, pursuant to section 174, take the care of a reasonably diligent director in carrying out this obligation. At common law shareholders' interests included both present and future shareholders.<sup>1</sup> Although section 172(1)(a) requires that regard be had to the consequences of the decision in the long term it does not specifically distinguish between present and future members. Following section 170(4)'s instruction to interpret section 172 in accordance with prior case-law this present and future members requirement would appear to be part of section 172. However, in a takeover or contemplated takeover taking into account future members is nonsensical. The future shareholder, if the bid is successful, is the bidder and his interest is paying the lowest price whereas the current shareholder's financial interest is in obtaining the highest price. Accordingly, in a bid context the member constituency of relevance is only the present members.<sup>256</sup>

In a commercial company where the shareholder's acceptance of the bid results in his exit from a relationship with the company there is only one factor that can plausibly be taken into account by the board: obtaining the highest value for the shares. The shareholders may of course have other preferences: a commitment to what the shareholder sees the company as representing, its history or its product. However, these are not identifiable preferences that could be considered and calibrated by a board. In a bid context, therefore, section 172 logically requires the decisions that the directors make will be those that they consider will generate the highest value for the current shareholders, and section 174 requires that the directors take reasonable care to facilitate this objective. Importantly, however, this does not

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<sup>256</sup> See *Heron International Ltd v Lord Grade, Associated Communications Corp plc and others* [1983] BCLC 244 affirming this view: see quote below.

require the adoption of a particular procedure to sell the company or require a recommendation to accept the highest bid – although in some circumstances duty compliance may be suspect in their absence.

A board of a target company that is approached by a strategic buyer who requires board agreement neither to talk to other parties nor recommend another party's bid may be duty compliant if at the time of agreeing those provisions the directors considered that this was the best way of ensuring that an offer is made – perhaps, for example, because of the difficulty that the company has had in finding a buyer willing to commence the bidding process. If the company has made this duty-compliant commitment, then clearly even if a higher bid is made the board is not required to, and cannot, recommend that higher bid. Alternatively, where a board of directors of a target company is approached by a bidder where it is likely that there would be multiple interested bidders, if the board recommended this initial bid having failed to put in place a process through which the board could assess other potential interest in the company or encourage others to express their interest, then question marks over section 172 and, particularly, section 174, compliance would be raised.

The pre-Act case-law on whether directors have an obligation to facilitate the highest bid and to recommend the highest bid support the above contention. In *Heron International Ltd v Lord Grade, Associated Communications Corp plc*, Lawton LJ held that:

Where directors have decided that it is in the interests of a company that the company should be taken over, and where there are two or more bidders, the only duty of the directors... is to obtain the best price. The directors should not commit themselves to transfer their own voting shares to a bidder unless they are satisfied that he is offering the best price reasonably obtainable. Where the directors must only decide between rival bidders, the interests of the company must be the interests of the current shareholders. The future of the company will lie with the successful bidder. The directors owe no duty to the successful bidder or to the company after it has passed under the control of the successful bidder. The successful bidder can look after himself, and the shareholders who reject the bid and remain as shareholders do so with their eyes open, having rejected that price which the directors consider to be the best price reasonably obtainable. Thus... the directors owed a duty to the general body of [current] shareholders to obtain for the shareholders the opportunity to accept or reject the best bid reasonably obtainable.

The basic premise that the 'duty of the directors... is to obtain the best price' for the 'current shareholders' is correct. However, as noted above, a duty to obtain the best price does not necessitate recommending the highest bid or putting in place an auction of the company. It may do, depending on the context, but it need not. Lord Cullen in *Dawson International plc v Coats Paton plc*<sup>257</sup> reaffirms this view when in considering *Heron International Ltd* he observes that:

I do not consider that the case is authority for the proposition that directors may not on behalf of the company agree to recommend a bid and not to encourage or co-operate with an approach from another would-be bidder without being in breach of a fiduciary duty to the current shareholders. In passing I would add that the case is also not authority for the proposition that directors are under a positive duty to recommend a bid on the basis that it is the higher bid.

In making the above observations Lord Cullen cites with approval Hoffmann J's (as he then was) first instance judgment in *Re a Company*<sup>258</sup> where a petitioner brought an unfair prejudice petition on the basis that the directors had failed to recommend or facilitate a higher bid and instead had given hard irrevocable undertakings to a lower price bidder:

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<sup>257</sup> [1989] BCLC 233.

<sup>258</sup> *Re a Company* [1986] BCLC 382.

I cannot accept the proposition that the board must inevitably be under a positive duty to recommend and take all steps within their power to facilitate whichever is the highest offer. In a case such as the present, where the directors propose to exercise their undoubted right as shareholders to accept the lower offer in respect of their own shares and, for understandable and fully disclosed reasons, hope in their personal capacities that a majority of other shareholders will accept it as well, it seems to me that it would be artificial to say that they were under a positive duty to advise shareholders to accept the higher offer. The fact that they would get more money by taking the higher offer is hardly something which needs to be pointed out. I do not think that fairness can require more of the directors than to give the shareholders sufficient information and advice to enable them to reach a properly informed decision and to refrain from giving misleading advice or exercising their fiduciary powers in a way which would prevent or inhibit shareholders from choosing to take the better price.

It is important to carefully parse this holding, which, although correct, is easily misinterpreted. Boards are under a duty in a takeover context to take steps to maximize the price offered for the shares.<sup>259</sup> But this does not logically result in a duty to recommend and to facilitate the acceptance of what at the end of the process ends up being the highest offer. Circumstances can, however, be envisaged where they would be under such an obligation. If during the bid process the board had not committed to making a recommendation or to any no-talk, non-solicitation or non-withdrawal provision and there was no impediment – such as a majority hard irrevocable commitment to a particular lower bid – to any of the bids, then a final board recommendation to accept the lower bid is likely to be highly suspect in terms of duty compliance. Of course section 172 is a subjective duty so a director who makes a ridiculous decision is duty compliant if he thinks such a decision promotes the success of the company for the benefit of the members. However, as we saw in Chapter 10, a court will, in absence of definitive proof of state of mind, require plausible reasons for a decision which would, in the above hypothetical, be difficult to find.

A further noteworthy issue is raised by these cases. Lawton LJ in *Heron International* is clearly of the view that a director's position affects his ability to make a disposal decision in relation to his shares: he should not agree to transfer his shares unless satisfied that the offer represents the best price available. This view, it is respectfully submitted, is incorrect. Shareholders may dispose of their shares on the terms that they are willing to accept provided such disposal accords with the company's constitution. The fact that a shareholder is a director makes no difference in this regard. In this regard Hoffmann J correctly refers to the directors-as-shareholders' 'undoubted right... to accept the lower offer'.

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<sup>259</sup> Although, as argued above, boards are in a takeover context under an obligation to take steps that they consider will facilitate highest value offers, which may in some instances involve facilitating a competitive bidding process, an important policy question remains outstanding as to whether such an objective is a good idea. From the shareholders in a particular company's perspective clearly it is. They are interested in maximizing the price offered for the shares and the return on their original investment. However, from a broader market perspective there are arguably downsides from requiring boards to facilitate competitive bidding, namely that this may reduce activity in market for corporate control and thereby undermine the disciplining effect on managerial agency costs of this market place. See further in this regard: F. Easterbrook and D. Fischel, 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94 *Harvard Law Review* 1161; F. Easterbrook and D. Fischel, 'Auctions and Sunk Costs in Tender Offers' (1982) 35 *Stanford Law Review* 1; L. Bebchuk, 'The Case for Facilitating Competing Tender Offers: A Reply and Extension' (1982) 35 *Stanford Law Review* 23; R. Gilson, 'Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense' (1982) 35 *Stanford Law Review* 51.

## 9 The offer timetable

The Takeover Code imposes tight control over the timing of the different stages of the takeover bid. This control contributes to the fulfilment of three of the Code's objectives: first, it enables the target shareholders to make a considered and informed decision;<sup>260</sup> second, it ensures that the target company is not operating under siege – in the distracting shadow of takeover activity – for an excessive period of time;<sup>261</sup> and, third, it ensures that takeover bids in the UK market are conducted orderly and predictably.<sup>262</sup>

All aspects of the bid are subject to clear rules on timing. The primary rules are as follows:

- The offer document must be published and sent to the shareholders within 28 (calendar) days<sup>263</sup> of making the '2.5' announcement of the firm intention to make an offer.<sup>264</sup>
- The target board's opinion on the offer required pursuant to Rule 25 must be posted 'as soon as practicable' following publication of the offer and 'normally within 14 days'.<sup>265</sup>
- The offer must remain open for acceptances for at least 21 days following the publication of the offer.<sup>266</sup> This '21-day after the offer' date is referred to as 'the first closing date'.
- The offer may be extended beyond this first closing date. Any extension must state the next 'closing date'.<sup>267</sup> However, the Code subjects such extensions to the following requirements:
  - Without the consent of the Panel the offer cannot remain open for longer than 60 days after the publication of the offer document *if* at 'day 60' the offer is not 'unconditional as to acceptances'; that is the offer has not received enough target shareholder acceptances to satisfy the acceptance condition specified in the offer. If it has not, then the offer cannot remain open *unless* the Panel grant

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<sup>260</sup> Takeover Code, General Principle 2.

<sup>261</sup> Takeover Code, General Principle 6.

<sup>262</sup> Takeover Code, Introduction, para 2(a) observing that 'the Code also provides an orderly framework within which takeovers are conducted' and that 'the Code has been developed since 1968 to reflect the collective opinion of those professionally involved in the field of takeovers as to appropriate business standards and as to how fairness to shareholders and an orderly framework for takeovers can be achieved'.

<sup>263</sup> Unless otherwise stated where this chapter refers to a number of days, the days are calendar days not business days. A business day is defined in the Code as a day on which the London Stock Exchange is open (Takeover Code, Definitions).

<sup>264</sup> Takeover Code, Rule 30.1.

<sup>265</sup> Takeover Code, Rule 30.2.

<sup>266</sup> Takeover Code, Rule 31.1.

<sup>267</sup> Takeover Code, Rule 31.2.

their approval to extend the offer, which they will normally do in, among others, either a competitive situation or if the target board consents to the extension of the offer.<sup>268</sup> If another competitor enters the bidding arena then the '60-day rule' will be measured by reference to the publication of the competitor's offer document.<sup>269</sup>

- If the offer is unconditional as to acceptances at the first closing date or at a subsequent closing date, the offer may remain open for acceptances beyond the 60-day period. A reason for doing this might be where the acceptance condition is below 90% of outstanding shares but where the bidder would prefer to reach that threshold in order to be able to exercise a squeeze-out right if necessary.<sup>270</sup> In these circumstances the bid may remain open until further notice. If the offer remains open until further notice beyond the 70-day period after the publication of the offer the bidder must give 14 days' notice before closing the offer.<sup>271</sup>
- If the bidder explicitly states that the offer will not be extended beyond a particular date he will not be able to extend the bid beyond that date save in exceptional circumstances including, most importantly, if a competitor enters the bid process after a 'no extension' statement has been made.<sup>272</sup>
- If the offer is revised the Code requires that the bid remains open for an additional 14 days. This means that, as the offer cannot remain open if it is not unconditional for acceptances at day 60, it cannot be amended after day 46 unless the Panel has granted approval for the offer to remain open beyond day 60. If a competing offer is made then the Day 46 limitation on revised offers will apply as of the date of publication of the competing offer. However, even where no competing offer has been made, where there is a potential competing offer – which need not have been announced – the Panel will normally grant an extension of the 60-day rule to enable revision by the original offeror if the target board consents, which they are highly likely to do given that the revision will involve an increased offer.<sup>273</sup>
- As discussed above in section 8, where a competitive situation continues to exist as of day 46 (measured from the publication of the offer of the last competitor) then the offerors will be allowed to make revised bids in accordance with the Code and the Panel's auction procedures.
- If the offer is extended beyond the first closing date but is not unconditional as to acceptance by day 42 then the shareholders who have accepted the offer are entitled to withdraw from the offer.<sup>274</sup>

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<sup>268</sup> Takeover Code, Rule 31.6.

<sup>269</sup> Takeover Code, Note 4 to Rule 31.6.

<sup>270</sup> Section 979 CA 2006; see B. II.5.5 above.

<sup>271</sup> Takeover Code, Rule 31.2.

<sup>272</sup> Takeover Code, Rule 31.5.

<sup>273</sup> Takeover Code, Practice Statement No 8, Timetable extensions in potentially competitive situations (2005).

<sup>274</sup> Takeover Code, Rule 34.

- Pursuant to Rule 31.9, after Day 39 after the day upon which the offer document was published the target may not, without the approval of the Panel, disclose new material information. This includes 'trading results, profit or dividend forecasts, asset valuations and proposals for dividend payments and any material acquisition or disposal'. Rule 31.9 notes that the Panel will be willing to grant an extension – normally to Day 46 – where a pre-Day 39 disclosure is 'not practicable'.<sup>275</sup>
- Once the offer has become unconditional as to acceptances the Code imposes a mandatory extended offer period of *at least* an additional 14 days.<sup>276</sup>
- All conditions to the offer must be satisfied within 21 days of *either the latter of* the first closing date or the date the offer became unconditional as to acceptances. The Panel may grant an exception in this regard but such consent will 'normally only be granted if the outstanding condition involves a material official authorization or regulatory clearance'.<sup>277</sup>
- The bidder must pay the target shareholders the consideration for the shares within 14 days of the later of the 'first closing date' or the date that all the conditions to which the bid was subject are satisfied.<sup>278</sup>

**Figure 2: Summary takeover timetable**

| Summary Takeover Timetable              |               |                      |                    |                             |                        |   |                                 |                           |  |
|---|---------------|----------------------|--------------------|-----------------------------|------------------------|---|---------------------------------|---------------------------|--|
| Announcement of intention to make offer | Offer is made | Target Board Opinion | First Closing Date | Withdrawal Rights Available | Last date for Revision | Last date for unconditional as to acceptances | All Conditions to be fulfilled* | Consideration to be paid* |  |
| - (28) days                             | Day 0         | Day 14               | Day 21             | Day 42                      | Day 46                 | Day 60  | Day 81                          | Day 95                    |  |

\*Assuming unconditional as to acceptances on day 60

**Questions:**

1. In light of our analysis in section II above, what in your view is a fitting adjective for the Takeover Panel's approach to regulation?
2. What is the relationship between the Takeover Code and company law?

<sup>275</sup> For a recent example where such approval was given (a three day extension) see Takeover Panel Statement 2009/32 *Cadbury Plc and Kraft Foods Inc.*

<sup>276</sup> Takeover Code, Rule 31.4.

<sup>277</sup> Takeover Code, Rule 31.7.

<sup>278</sup> Takeover Code, Rule 31.8.

3. In what ways does the Takeover Code ensure that shareholders are treated equally?
4. Why should holders of non-voting shares be entitled to receive an offer for their shares simply because an offer is made for the voting shares?
5. Whilst an inducement fee of 3% of the deal value may be in breach of the Takeover Code, is it consistent with company law?
6. 'The Takeover Code inhibits efficient deals by imposing a defacto cap on inducement fees at 1%. This is an unjustifiable interference with freedom of contract.' Discuss.
7. 'The Takeover Panel should not concern itself with bid conditionality. Boards and shareholders are perfectly capable of assessing the risks associated with bid conditionality. There is no need for a paternalistic regulator in this regard.' Discuss.
8. Why shouldn't bidders and target companies be allowed to agree on what amounts to, and who determines whether there has been, a material adverse change?

### III The mandatory bid

#### 1 *Mandatory versus voluntary bids*

Thus far in Part B of Web Chapter A our analysis has focused on the voluntary bid: where a bidder elects to make a bid in circumstances where he is not obligated to do so. In addition, the Takeover Code provides for a mandatory bid, which is a bid that the bidder is *required* to make if he acquires shares or 'interests in shares' carrying more than the specified threshold of the voting rights in the company. Perhaps the terms 'voluntary' and 'mandatory' are somewhat misleading because in practice an informed bidder will be fully aware that he is crossing the mandatory bid threshold and thereby incurring the mandatory bid requirement.<sup>279</sup> Where the bidder voluntarily elects to cross the threshold and incur the mandatory bid obligation, this is hardly distinguishable from a voluntary decision to make a bid. As we shall see below the terms of a mandatory bid are in several respects more onerous than the terms of a voluntary bid, discussed above. However, there may be one important advantage of 'electing' for the mandatory bid which is that the bidder can acquire a greater portion of the company's voting share capital (30% or more) before the bid is made, which increases the chances of the success of the bid. This may be particularly advantageous where the board of the target company is opposed to, or likely to be opposed to, the bidder's advances.<sup>280</sup> Mandatory bids are relatively rare although several such bids typically occur each year. For example: in 2006 11 of the year's 151 bids were mandatory bids;<sup>281</sup> in 2007, 5 of 144 bids were mandatory bids;<sup>282</sup> and in 2008, 9 of 134 bids were mandatory bids.<sup>283</sup>

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<sup>279</sup> Inadvertent breaches, although rare, do take place: see the inadvertent breach of Rule 9, which resulted in public criticism by the Panel of N M Rothschilds – N M Rothschilds & Sons Ltd (Takeover Panel Statement) 2007/06.

<sup>280</sup> Note in this regard that if a voluntary bid is commenced when the bidder holds voting shares below the mandatory bid thresholds, discussed below, but then after commencing the voluntary bid crosses those thresholds then a mandatory offer in accordance with the terms of a mandatory offer rules must be made: see Takeover Code, Note 9 to Rule 9.1.

<sup>281</sup> Takeover Panel 2007 Annual Report.



## 2 Rule 9.1: the mandatory offer

### Takeover Code

#### **Rule 9.1 When a mandatory offer is required and who is primarily responsible for making it**

Except with the consent of the Panel, when:—

- (a) any person acquires, whether by a series of transactions over a period of time or not, an interest in shares which (taken together with shares in which persons acting in concert with him are interested) carry 30% or more of the voting rights of a company; or
- (b) any person, together with persons acting in concert with him, is interested in shares which in the aggregate carry not less than 30% of the voting rights of a company but does not hold shares carrying more than 50% of such voting rights and such person, or any person acting in concert with him, acquires an interest in any other shares which increases the percentage of shares carrying voting rights in which he is interested,

such person shall extend offers, on the basis set out in Rules 9.3, 9.4 and 9.5, to the holders of any class of equity share capital whether voting or non-voting and also to the holders of any other class of transferable securities carrying voting rights. Offers for different classes of equity share capital must be comparable; the Panel should be consulted in advance in such cases. An offer will not be required under this Rule where control of the offeree company is acquired as a result of a voluntary offer made in accordance with the Code to all the holders of voting equity share capital and other transferable securities carrying voting rights.

There are two mandatory bid obligations set out in Rule 9. The first, in sub-rule (a), obligates a person to make a bid where that person, *together with persons acting in concert with him*, crosses the 30% voting rights threshold. The second obligation, in sub-rule (b), obligates a person to make a bid where that person, *together with persons acting in concert with him*, already owns shares which give him 30% but less than 50% of the voting rights. There is no obligation for a person who already controls 50% of the voting rights to make a bid upon acquiring additional shares (or interests in shares) in the company.

There are three key concepts that determine the scope of application of these mandatory bid rules:

- First, the rules apply not to an acquisition of a percentage of ordinary shares but to voting rights thresholds. It is typical for companies in the UK to have only one class of ordinary voting shares; however, it is possible for companies to have shares with weighted or multiple voting rights.<sup>284</sup> Accordingly, the acquisition of shares with multiple voting rights could result in the triggering of the mandatory bid rules where the percentage of shares owned is below the above thresholds.
- Secondly, the rules do not apply exclusively to the acquisition of shares carrying voting rights but rather to any acquisition of an 'interest in shares' carrying voting rights. For

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<sup>282</sup> Takeover Panel 2007 Annual Report.

<sup>283</sup> Takeover Panel 2008 Annual Report.

<sup>284</sup> See generally Chapter 17.

the Code a person has an interest in shares where that person has ‘long’<sup>285</sup> economic exposure, whether absolute or conditional to changes in the price of shares. In addition to shares carrying voting rights it includes options to purchase the shares, the right to convert debt into shares and derivatives such as contracts for difference.<sup>286</sup> Options and convertible securities are ‘interests in shares’, and, therefore, Rule 9 requires that the votes that would be attached to the shares purchased by the exercise of those rights should be aggregated with other voting rights held by that person. However, the Code excepts from this aggregation options and warrants for *new shares* but not options to purchase already issued shares.<sup>287</sup> Through the application of the mandatory bid rules to acquisitions of interests in voting shares rather than just voting shares this ensures that the rule applies where a threshold controlling influence is acquired as well as where an actual threshold controlling shareholding is acquired. The use of the ‘interests in shares’ concept and its broad definition are in effect an anti-evasion technique to ensure that a company’s astute advisors cannot enable that company to *effectively* cross the mandatory bid thresholds without triggering a mandatory bid.

- Thirdly, Rule 9 requires not only the aggregation of the interests in shares acquired by the person in question but also anyone *acting in concert* with such person. Clearly, the rule would be ineffectual if the interests in shares held by the applicable person were not aggregated with the interests in shares held by that person’s associates, controlled entities or other persons who agreed to act together with that person. The use of the concept *acting in concert* is, as with interests in shares, an anti-rule evasion technique. In this regard consider the following observations;
  - The term is very broadly defined. The definition of the term in the Code is one page long and the notes on the definition are two and a half pages long. An additional five pages of notes on the application of the term ‘acting in concert’ to the mandatory bid are provided in the Notes to Rule 9.1. The general definition of acting in concert is as follows:

Persons acting in concert comprise persons who, pursuant to an agreement or understanding (whether formal or informal), co-operate to obtain or consolidate control<sup>288</sup>... of a company or to frustrate the successful outcome of an offer for a company. A person and each of its affiliated persons will be deemed to be acting in concert all with each other.

- The definition focuses clearly upon preventing persons from evading the mandatory bid rule and the non-frustration rule, which we consider in IV below, by effectively amalgamating all parties cooperating together. This would include, amongst others: the subject person’s majority-owned companies or subsidiaries; parent company; directors, directors’ relatives or trust funds; any company in which the subject company owns 20% of the voting shares (an ‘associated

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<sup>285</sup> An economic position is long where the person holding that position’s wealth is a direct function of the value of that share. In contrast a person with a short position benefits economically if the actual price of the share goes down and loses if it increases. A short sale involves the sale of a borrowed share where the seller expects the value of the share to drop at which point he will buy back the share and return it to the lender.

<sup>286</sup> Contracts for difference are explained in fn 133 above.

<sup>287</sup> Takeover Code, Note 10 to Rule 9.1.

<sup>288</sup> Control is defined as ‘an interest, or interests, in shares carrying in aggregate 30% or more of the voting rights... of a company, irrespective of whether such interest or interests give de facto control’.

company’); the company’s pension fund or fund manager; and all members of any consortium.

- The acting in concert definition creates difficulties for investors who work together to monitor and discipline a company’s board of directors. As we observed in Part II of this book a significant problem in the context of the governance of companies that are widely held is that the shareholder base may act in a rationally apathetic manner and fail effectively to monitor and discipline the board. One reason for shareholder rational apathy is the costs of collective action. Where investors are willing to cooperate to monitor and discipline managers it would be perverse if regulation deterred them from so acting. The mandatory bid rule as applied to parties acting in concert has the potential to act as such a deterrent. If by exercising collective power to influence the board or change its composition such a group of activist investors are deemed to be acting in concert for the purposes of Rule 9 then many potentially active investors will be wary about acting together with parties who together control the relevant threshold of voting shares. The Code is, however, cognizant of this problem. In effect, collective shareholder activism will not fall within the definition of ‘acting in concert’ provided that the group of investors’ activism does not involve a ‘board control-seeking’ shareholder resolution that aims to replace a majority of the current board.<sup>289</sup>
- Given the consequences of a person being found to be acting in concert with another person where the amalgamated interests in shares cross the mandatory bid threshold, great care needs to be taken by a company and its advisors when acting together with any other party in relation to a third company. While the Panel may waive the mandatory bid requirement for inadvertently crossing the threshold,<sup>290</sup> it will sanction the parties responsible for such inadvertent breaches.<sup>291</sup>
- Where a group of persons are deemed to be acting in concert and following the additional purchases of shares by one of the their amalgamated interests in voting shares cross the 30% mandatory bid threshold then pursuant to Rule 9.2 ‘each of the principle members of the group... [has] the obligation to extend an offer’. Note that a mandatory bid will not normally be required when the existing shares of the newly formed concert group exceed the mandatory bid threshold. In such circumstances, the mandatory bid will only be required upon the purchase of additional shares after the coming together of the concert parties.<sup>292</sup> The Note to Rule 9.2 clarifies that the ‘prime responsibility’ for making the offer

<sup>289</sup> Takeover Code, Note 2 to Rule 9.1. Guidance on what amounts to a ‘board control seeking resolution’ is provided in Panel Executive Practice Statement NO. 26 (2009/18) which observes in this regard that ‘a resolution will not normally be considered to be “board control-seeking” unless it seeks to replace existing directors with directors who have a significant relationship with the requisitioning shareholders with the result that those shareholders would effectively be in a position to control the board. A resolution will not normally be considered to be “board control-seeking” if the directors to be appointed are independent of the activist shareholders or if the primary purpose of the proposal is to appoint additional non-executive directors in order to improve the company’s corporate governance.’

<sup>290</sup> Takeover Code, Notes on dispensations from Rule 9, Note 4.

<sup>291</sup> N M Rothschilds & Sons Ltd (Takeover Panel Statement) 2007/06.

<sup>292</sup> Takeover Code, Note 1 to Rule 9.1.

attaches to the person whose acquisition of an interest in shares results in the group which is *acting in concert* crossing the mandatory bid threshold.<sup>293</sup>

- The Code provides for dispensation from the mandatory bid obligation in a set of very limited circumstances, including the following:
  - Where the crossing of the mandatory bid threshold results from the issue of new securities by the target company the Panel will ‘normally’ provide for the dispensation from the mandatory bid obligation where the independent shareholders<sup>294</sup> vote in general meeting to approve of the dispensation. This is known as a ‘whitewash’ of the mandatory bid obligation.<sup>295</sup>
  - The ability for the shareholders to whitewash the mandatory bid obligation is normally only available where the thresholds are crossed as a result of the issue of new securities, not where the shares are purchased from existing holders of ‘interests in shares’. The Code does, however, provide that in ‘exceptional circumstances’ the Panel will consider a dispensation where the threshold *would* be crossed by the purchase of existing interests in shares.<sup>296</sup>
  - The Panel will normally grant dispensation from the mandatory bid requirement if it is crossed by a lender as a result of the enforcement of the security for the loan, provided that the lender subsequently disposes of sufficient shares to take his ownership below the 30% threshold.<sup>297</sup>
  - The Panel *may* grant dispensation where the company is in ‘such a serious financial position that the only way it can be saved is by an urgent rescue operation’ involving the issue or purchase of securities that results in crossing a mandatory bid threshold. No whitewash is required in such circumstances but the Panel will require either an ex-post whitewash or some other form of protection for the independent shareholders.<sup>298</sup>
  - The Panel *may* grant dispensation following the inadvertent crossing of the threshold provided that the holding is reduced below the threshold.<sup>299</sup>

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<sup>293</sup> Note that if the concert party member who buys the additional shares is not a ‘principal member of the group the bid obligation will attach to the principal member or members (Note to Rule 9.2).

<sup>294</sup> The term is not a defined term in the Code but should be understood to mean any shareholders other than the bidder or persons acting in concert with the bidder.

<sup>295</sup> Takeover Code, Notes on Dispensation to Rule 9, Note 1(a). Detailed guidance on whitewash procedure and the information to be provided to shareholders when proposing a whitewash resolution is provided by the Panel in Appendix 1 to the Code: *Whitewash Guidance*.

<sup>296</sup> Takeover Code, Notes on Dispensation to Rule 9, Note 1.

<sup>297</sup> Takeover Code, Notes on Dispensation to Rule 9, Note 2.

<sup>298</sup> Takeover Code, Notes on Dispensation to Rule 9, Note 3.

<sup>299</sup> Takeover Code, Notes on Dispensation to Rule 9, Note 4.

- The Panel *may* grant dispensation where the holders of 50% of the shares provide in writing that they would not accept the offer or where 50% of the shares are already held by one person.<sup>300</sup>

### 3 *The terms of the mandatory bid*

The terms of the mandatory bid differ in important respects from the terms of a voluntary bid. In particular note the following requirements:

- The offer *must* be a cash offer or accompanied by a cash alternative.<sup>301</sup>
- As with a voluntary bid, the bidder must make comparable offer for different classes of shares and also an appropriate offer for other convertible securities.
- The price to be paid must be at least the highest price paid in the 12 months prior to the announcement of the offer.<sup>302</sup> This contrasts with Rule 6 in relation to voluntary bids, which provides for an offer at least as high as the highest price in the three months prior to announcement.<sup>303</sup>
- Rule 9.3 provides that without the consent of the Panel the bid cannot be subject to *any* conditionality apart from: (1) a condition that the bidder must receive acceptances that, together with shares acquired prior to the bid, result in the bidder holding 50% of the target company's shares; and (2) any required approval from the UK or EU competition authorities.<sup>304</sup> If the making of a mandatory offer would require, or 'might be dependent' on obtaining, any other consent or approval, from shareholders or otherwise, then the Code provides that the person or persons acting in concert cannot cross the mandatory bid threshold.<sup>305</sup> To do so and then to claim that any bid is subject to such a condition or approval would be a breach of the Code. By tightly controlling conditionality, the Code removes from the bidder any scope to control the terms upon which he is willing to make an offer. However, Note 3 to Rule 9.3 provides that dispensations from these strict rules on conditionality may be granted where securities will be issued to raise cash for the bid and where shareholder approvals are required to issue securities, or where other regulatory approvals are required prior to the making of the offer.
- Rule 2 requires that immediately upon incurring an obligation to make a bid pursuant to Rule 9 an announcement must be made that an obligation to make an offer has been incurred. The rules on the timing of the offer outlined in B.II.9 above apply also to mandatory bids.

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<sup>300</sup> Takeover Code, Notes on Dispensation to Rule 9, Note 5.

<sup>301</sup> Takeover Code, Rule 9.5.

<sup>302</sup> Takeover Code, Rule 9.5.

<sup>303</sup> In relation to a voluntary bid, a 12-month period is provided for where a cash bid is required pursuant to Rule 11 of the Takeover Code.

<sup>304</sup> Takeover Code, Rule 9.4.

<sup>305</sup> Takeover Code, Rule 9.3(b).

## 4 The function of the mandatory bid rule

### 4.1 Protecting minority shareholders

General Principle 1 of the Takeover Code provides that 'if a person acquires control of the company, the holders of the securities must be protected'. The mandatory bid rule is widely viewed as a means of protecting minority shareholders from possible future exploitation by the new controller of the target company. Consider in this regard the following extract.

**P. Davies, 'The Notion of Equality in European Takeover Regulation' in J. Payne and D. Prentice, *Takeovers in English and German Law* (Hart, 2002)**

The mandatory bid operates in two ways to secure the interests of non-controlling shareholders. First, the unilateral exit right at a fair price can be presented as a pre-emptive strike at illegal acts of oppression of the minority which the new controller may engage in. This argument depends upon establishing that the remedies which company law grants in the face of actual oppression are inadequate, for otherwise it is difficult to see why the shareholder should have a right of exit as a protection against illegal acts which may or may not occur. The fact that a particular person has acquired a controlling position in the company does not normally justify a prediction of future illegal acts.<sup>306</sup> Nevertheless, in systems where minority protection remedies are weak, either because the law does not provide any or because it is difficult to show that the relevant rules or standards have been transgressed by the controlling shareholder, the mandatory bid rule does provide non-controlling shareholders who anticipate unlawful conduct with an effective remedy, albeit one which requires the shareholder to terminate his or her relationship with the company entirely on the basis of a possibly difficult judgement about the future conduct of the new controller.

An alternative and less demanding rationale, which assumes that the new controlling shareholder will remain on the correct side of the dividing line between legality and illegality, is that the interests, if not the rights, of the non-controlling shareholders are likely to be adversely affected by a change of control. The acquirer, even if it does not intend to loot the company, may embark upon a different and less successful strategy; may be less respectful of the minority's interests and rights; or may just simply use the acquired control systematically for implementing a group strategy at the expense of the new group member company and its minority shareholders. In the last case, where a previously independent company becomes a member of a group, there will be no guarantee that it, rather than some other company in the group, is given the opportunity to attack a promising new market or to develop a promising new product. For the shareholders of the holding company it may be beneficial that these opportunities be allocated to another group member, but in that situation the minority shareholders in the new subsidiary will lose out...

A final and important aspect of the *ex post* impact of the mandatory bid rule should now be noticed. It protects the non-controlling shareholders against anticipated disadvantageous conduct on the part of the new controller of the company, whether or not that control was purchased from an existing controlling shareholder or was put together as a result of a number of separate, small purchases on the market or otherwise. In other words, what the mandatory bid rule concentrates on is the *acquisition* of control, whether or not it is accompanied by a *transfer* of control from an existing controlling shareholder. Or to put the matter another way, transfers of control from management to bidder are within the scope of the rule, just as transfers of control

<sup>306</sup> 'Though it may do if the acquirer has a history of looting target companies.'

from existing controlling shareholders are. It might be said that transfers of control from existing controlling shareholders should not be within the rule, because the non-controlling shareholders were subject to a controlling shareholder before the transfer and are still so subject after it, and so their position has not worsened. However, it can be responded that the risk of exploitation of control, to the disadvantage of the non-controlling shareholders, may be greater with the transfer of control to a new shareholder (especially where the existing controlling shareholder has sold its controlling shareholding dearly), just as it is the risk of disadvantageous conduct which, we have seen, underlies the mandatory bid rule when it is applied to transfers of control from management to controlling shareholder.

While the mandatory bid rule may correctly be viewed as an instantiation of the Code's General Principle 1 – requiring the protection of minority shareholders following a change of control – it is not clear in the UK context that this minority protection justification explains all aspects of the Code's mandatory bid rule. Clearly it applies to Rule 9.1(a) where control is transferred or acquired by crossing the 30% threshold. However, it only makes partial sense of Rule 9.1(b). If 30% is understood to represent control for the purposes of the Code then the acquisition of additional interests in shares by a person who already controls more than 30% of the voting rights does not involve either a transfer or an acquisition of control, rather only a consolidation of control by a controller to whom the minority shareholders were already exposed. However, the 30–50% mandatory bid requirement is consistent with this minority protection rationale in relation to concert parties that when they come together own in aggregate greater than 30% of the shares. In such circumstances control is arguably transferred to the concert group and the 30–50% mandatory bid rule gives minority shareholders an opportunity to exit from this new control block when the concert group attempts to consolidate control.<sup>307</sup>

Furthermore, as Professor Davies points out, a justification based upon protecting minority shareholders from exploitation by the controlling shareholder assumes that such a rule actually provides them, in practice, with protection in this regard. If other company law rules providing for minority protection effectively protect minority shareholders, then there may be only a limited amount of additional protection that the mandatory bid rule can actually provide. In this regard, as we saw in Chapter 16, UK company law uses a range of legal strategies to protect minority shareholders. Empirical work by financial economists attempting to measure the market place's view of the scope to exploit minority shareholders in the UK suggests that there is a very limited degree of such exploitation.<sup>308</sup> However, as Professor Davies correctly infers, no matter how good the minority protection regulation or how benign the new controller, when a company becomes part of a group of companies it may lose out in ways it would not have, had it remained a stand alone entity. It may, for example, be prevented from expanding into business areas covered by other group companies, or from pursuing or exploiting suitable new business opportunities that the parent company wishes another group company to take. To the extent that a mandatory bid rule provides protection that other minority protection rules are incapable of providing, minority shareholders will pay for this protection in the increased price they are willing to pay for the shares to take account of the reduced scope for their exploitation.

<sup>307</sup> I am indebted to Edmund Schuster for clarifying this point.

<sup>308</sup> Dyck and Zingales provide a multi-jurisdiction assessment of premiums (above the prevailing market price) paid for control blocks of shares of more than 20% (and in the UK less than 30%). They argue that these control premiums are a proxy for private benefits of control as controllers pay more for the shares in the expectation of being able to extract benefits (private benefits of control) in the future. Whereas in many jurisdictions they find high control premiums paid, in the UK the control premium was only 1%, which they argue suggests very limited scope for private benefits of control in the UK – A. Dyck and L. Zingales, 'Private Benefits of Control: An International Comparison' (2004) *Journal of Finance* 59, 537–600.

## 4.2 Equality of treatment

An alternative rationale in support of the mandatory bid rule would be one based on the equal treatment objective of the Takeover Code: all shareholders should be entitled to participate in a change of control transaction and to share in the price paid to obtain control. This rationale is more persuasive in relation to widely-held companies where no one shareholder can be said to have control. In such circumstances one might say that the value of control is spread across the shareholder body and, accordingly, all shareholders should be allowed to participate in the control transaction. However, this rationale is weak in relation to companies that already have a controller and where that controller is selling his greater than 30% voting interest or buying more shares to consolidate that interest. In such circumstances the minority shareholders do not have control and they are no more treated unequally if they are not allowed to share in the control premium than would be a person who is not entitled to share in the proceeds of the sale of another person's asset.<sup>309</sup> Of course the right to share in the premium is a right that would be valued by minority shareholders and a right that they would be willing to pay for; but it is not a right that is justified by equality of treatment.

Two further points should be considered in regard to the above rationales. First, it is unclear why, even if the rules have the above functions that they should be mandatory rules. Alternatively, any mandatory bid rule could be placed in a company's constitution, at the company's election. Indeed, given that, as discussed below, requiring a mandatory bid may dampen takeover activity, as it makes obtaining control more expensive, there would be no disincentive for managers to propose such a change. Arguably the constitutional provision of a mandatory bid rule would be weaker than a mandatory rule as its provision in the constitution would be exposed to alteration by a special resolution in general meeting.<sup>310</sup> However, for companies making an IPO and wishing to maximize the value of their shares actually entrenching those rules would in most instances be unproblematic. Of course, entrenching a new mandatory bid provision in an existing widely held company would effectively be impossible, given the requirement to obtain 100% shareholder consent.<sup>311</sup>

The second consideration in relation to the above rationales is that the identified positive effects for minority shareholders will only reduce a company's cost of capital provided that those costs are not outweighed by any negative effects of the mandatory bid rule. Of particular importance in this regard is that a mandatory bid rule results in bidders having to pay more to obtain control of the company because the bidder must offer to purchase all shares and all securities convertible into shares. It follows that if legal regulation makes obtaining control more expensive there will be fewer value enhancing control transactions. Furthermore, less control activity would also undermine the disciplinary effect on managers of the market for corporate control.<sup>312</sup> In this regard consider the following extract.

<sup>309</sup> R. Hamilton, 'Private Sale of Control Transactions: Where We Stand Today' (1985) 36 *Case-Western Reserve Law Review* 248; F.H. Easterbrook and D.R. Fischel, 'Corporate Control Transactions' (1982) 91 *Yale Law Journal* 698; cf. W.D. Andrews, 'The Stockholder's Right to Equal Opportunity in the Sale of Shares' (1965) 78 *Harvard Law Review* 505.

<sup>310</sup> Section 21 Companies Act 2006.

<sup>311</sup> Section 22 Companies Act 2006. Entrenchment requires a 100% shareholder support.

<sup>312</sup> Cf. L.A. Bebchuk, 'Efficient and Inefficient Sales of Corporate Control' (1994) 109 *Quarterly Journal of Economics* 957, 970–1 questioning whether liquidity constraints would reduce takeover activity.



**L. Enriques, *The Mandatory Bid Rule in the Takeover Directive*.<sup>313</sup>  
*Harmonization without Foundation* (2004) *European Company and Financial Law Review* 440–57**

There is, however, broad consensus in the literature that, while obviously ex-post (ie, after a control transaction materialises) minority shareholders are better off with a mandatory bid rule in place, ex ante the rule inevitably reduces the number of value-increasing control acquisitions.<sup>314</sup> It is far from certain that the benefits to minority shareholders from protection against value-decreasing acquisitions (in the worst-scenario, by looters) are greater than the costs of lost opportunities for value-increasing acquisitions, the increased agency costs of reduced market discipline upon incumbent managers and blockholders and the efficiency loss deriving from the lesser adaptability of the industrial system to environmental changes...

One may attempt to justify equal treatment for minority shareholders in control transfers on economic grounds by likening mandatory bids to tips: as waiters accept lower wages if they can count on tips, minority shareholders will agree to buy shares at higher prices (incorporating the likelihood of receiving a ‘tip’ if control changes hands) if a mandatory bid rule is in place, so that ultimately the firm’s cost of capital is reduced (like restaurants’ cost of labour). However there is a problem with this line of reasoning.

As was argued with regard to the minority shareholder protection rationale, the mandatory bid rule results in less takeover activity. It is unclear why the minority shareholder (the market) should not take this into account in pricing shares; again it is impossible to state ex ante and in general... whether the presumed ‘tips’ would offset the adverse effects of the mandatory bid rule on takeover activity and on managerial discipline.

### 4.3 Ownership of the regulatory space

A third explanation of the birth and existence of the mandatory bid rule is one that understands the rule as a necessary precondition to ensuring that the Takeover Panel is effective as a regulator. Without a mandatory bid rule the ability of the Takeover Panel to assertively regulate voluntary bids is undermined. As we have seen, the Takeover Code imposes very stringent regulation of voluntary bids. If bidders had the option of incrementally acquiring control of the company without having to make a bid, the attractiveness of such an option would be a function of how costly the voluntary bid is, which is in part a function of the regulatory burden imposed upon such bid. The regulation of voluntary bids would therefore be constrained by the fear of driving market participants away from voluntary bids altogether into incremental acquisitions of control. From this viewpoint, a mandatory bid requirement is a necessary precondition to the successful regulation of voluntary bids.

It is noteworthy in this regard that the context which gave birth to the Takeover Code was one in which the early attempts to regulate market activity had not been successful and as a result the threat of government intervention had increased.<sup>315</sup> In the absence of a mandatory bid a

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<sup>313</sup> Article 5 of the Takeover Directive requires all member states to implement a mandatory bid rule.

<sup>314</sup> Citing L.A. Bebchuk, ‘Efficient and Inefficient Sales of Corporate Control’ (1994) 109 *Quarterly Journal of Economics* 957.

<sup>315</sup> See extract from Armour and Skeel in Web Chapter A, B.I above.

considerable amount of control activity is left unregulated and the ability to regulate voluntary bids undermined. This would leave considerable scope for control transaction events that create bad publicity for the market place as a whole and leave the Takeover Panel looking weak and ineffective, which again would result in an increased likelihood of government intervention. The mandatory bid rule can therefore be seen as the product of a particular historical moment when it was essential that the Takeover Panel asserted effective control over the takeover market place.

#### Questions and discussion:

1. Which of the mandatory bid rationales do you find more persuasive?
2. Given UK minority protection regulation, how much scope is there in practice for minority shareholders to be exploited by a new controller, whether that controller is an individual or a parent company, whose group of companies the target company now becomes part of?
3. What are the advantages and the disadvantages of becoming part of a group of companies? Are the disadvantages so ineffectively regulated by corporate law as to justify the mandatory bid rule?
4. If, as we observed in A.I of this chapter, the empirical evidence that the market for corporate control disciplines weak and self-serving management is weak, then an increase in market for corporate control activity is unlikely to have any additional disciplinary effect on managers. Does this empirical evidence problematize Professor Enriques' claim or does it remain valid?
5. Do any of the rationales considered in this section justify Rule 9.1(b)?
6. What is the justification for making the rules applicable to a mandatory bid more onerous than those applicable to voluntary bids? Why not simply make a mandatory bid subject to all the rules applicable to voluntary bids?

## IV Regulating takeover defences

### 1 *The takeover defence problem*

We saw in Part A section I that, *in theory*, the market for corporate control operates as a disciplinary device to ensure that managers do not act in their own interests and that they maximize their efforts within their capability constraint. From this perspective an effective market for corporate control operates as a mechanism for controlling managerial agency costs generally: misbehaviour increases the likelihood that managers may lose their jobs. However, as we also observed, the existing empirical evidence does not to date support the claim that this is how the market for corporate control operates in practice. In addition to this general relationship between managerial agency costs and the market for corporate control there is a specific and potentially acute managerial agency problem that arises from the fact of the bid itself. Directors and senior management of the company have much to lose from a bidder that does not see a role for these directors and managers in the future running of the company. Such directors may lose the financial benefits (both legitimate and illegitimate – agency costs) and the status and psychological benefits that controlling the company brings. To protect these benefits such directors may resist the bid even though the bid makes economic sense for the shareholders and the broader economy.

We have already discussed these conflicts in relation to the target board's opinion of the bid which it is required to give pursuant to Rule 25 of the Code. However, for the purposes of resisting a bid, in addition to the giving of their opinion, *in theory*, the target board has available to it the powers that have been delegated to them to run the company. These

powers, such as the power to issue shares, to sell assets and enter into contracts, could be used in various ways to frustrate, or place obstacles in the way of, a bid. To the extent that the use of such powers requires shareholder approval at the time the power is used, shareholders will be unconcerned as they can veto any proposed board action. The real concern is when the board uses these powers defensively where there is no requirement to obtain shareholder approval to do so. In such circumstances board action impinges upon shareholder sovereignty: the right to make the basic investment decision of whether or not to sell the shares for what the bidder offers for them.

For some commentators such board interference with this decision will, almost inevitably, be motivated by director self-interest. Consider, for example, the comments of the High Level Group of Company Law Experts established by the European Commission to look at takeover regulation in 2001, which concluded that:

Any *regime* which confers discretion on a board to impede or facilitate a bid inevitably involves unacceptable cost and risk... defensive mechanisms are often costly in themselves, apart from the fact that they deny the bidder the opportunity to create wealth by exploiting synergies after a successful bid. Most importantly management are faced with a significant conflict of interests if a takeover bid is made... their interest *is* in saving their jobs and reputation instead of maximising the value of the company for shareholders. Their claims to represent the interests of shareholders or other stakeholders are likely to be tainted by self-interest. Shareholders should be able to decide for themselves (emphasis added).<sup>316</sup>

There are, however, more benign justifications for the board using corporate powers to deter or prevent a takeover bid without obtaining ex-ante shareholder approval. There are four such benign justifications. First, it enables the board to protect shareholders who do not, or are incapable of, understanding the true value of the company. The reasons for such board superiority in understanding whether the offer provides value for money include: the board's superior knowledge base as a result of their 'learning by doing' advantage; and the fact that there may be confidential information available to the board that cannot be made available to the shareholders without damaging the competitive advantage which this information provides. The second benign justification is that once the company is placed in play by the approach from the initial bidder, takeover defences enable the target board to control the bid process and to give itself sufficient time to provide a target company alternative to the sale or time to find another third party bidder who is willing to pay a higher price. The third justification, closely related to the second, is that takeover defences enhance the target board's bargaining power vis a vis the bidder, which enables the target board to negotiate a better price for its shareholders. Finally, the availability of takeover defences enables the board to say no to a bid in order that it can get on with the job of running the company – to ensure that the company cannot be held siege by a bidder. Furthermore, in the absence of an actual or imminent bid such defences also, arguably, enable the managers to run the company without continually worrying about, and making decisions that take into account, the possibility of a future bid.

The problem with these justifications is that while in many instances they may reflect the reasons for board action they are also invariably available to act as a cover for director self-interest: claims that the company is worth more than the offer price and that target shareholders need to be protected from themselves is always available whether or not it is true; the search for a third party may be more a search for a third party who is more generous to the directors than to the shareholders; and whilst takeover defences may be used to extract better terms for target shareholders they may also be used to extract better terms for the managers of the target company, for example continued employment in the target or another bidder group company. Generally speaking, academic commentators and regulators in the UK are unpersuaded by the benign justifications outlined above and are much more receptive to the view expressed by the Winter Group set out above. This, as we shall see below, is

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<sup>316</sup> See High Level Group of Company Law Experts Report on Issues Relating to Takeover Bids (2000) (the Winter Report), 21.

reflected in the Takeover Code's prohibition of such defences. However, it is worth noting that there is an enormous 'consensus gap' between the US and the UK in relation to this debate. In this regard, Professor Subramanian of the Harvard Law and Business Schools puts it as follows:

No [US] academic commentator today (including myself) questions the... right of a target board to maintain a pill for a limited period of time, in order to identify a higher value buyer or to inform shareholders about the bid.<sup>317</sup>

The question that continues to generate acute controversy among US academic commentators is whether or not there should be a time-limit on the use of such defences: a legally mandated point in time when all defences should be withdrawn and the shareholders allowed to make a decision themselves. A considerable body of US academics and a clear majority of US practitioners would support the view that there should be no such limit. There is no space here to interrogate the US debate in detail. Additional readings are provided at the end of this section. The point to note here is that the US experience and the widespread support for the availability of takeover defences forces participants in the UK's debate to give careful consideration to the arguments set forth above in favour of such defences. These arguments are not viewed by all simply as camouflage for managerial self-interest: for many, it is not the case that managers primary interests is necessarily 'in saving their jobs and reputation instead of maximising the value of the company for shareholders'.<sup>318</sup>

## 2 Types of takeover defence and their formal availability under UK company law

To understand the regulation of takeover defences in the UK it is necessary to have a clear sense of the specific ways in which corporate powers can be used by boards of directors to defend against unsolicited/hostile takeover bids. We shall see in IV.3 below that the UK's Takeover Code imposes a general prohibition on the use of takeover defences in the absence of contemporaneous – at the time of the bid – shareholder approval. However, before we analyse this prohibition we need to understand what exactly this prohibition is prohibiting the use of. We need to understand the extent to which English company law enables the construction of takeover defences that could be deployed by the board without having to ask for contemporaneous approval from the shareholder body.

In this regard, we draw on the experience of the US where target boards are empowered to use takeover defences provided that the use of the power is reasonable in relation to the threat to the target company represented by the hostile bid.<sup>319</sup> One important, if banal, lesson from the US in this regard is that the scope for the board to use corporate powers for defensive purposes is a function of corporate law rules that regulate the use of the basic corporate powers such as: the ability to enter into contracts, to issue shares, to raise debt or to make a dividend. As we see in the extract below, whilst drawing on US experience it is

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<sup>317</sup> G. Subramanian, 'Bargaining in the Shadow of Takeover Defences' (2003) 113 *Yale Law Journal* 621, 654.

<sup>318</sup> Winter report above at fn 316.

<sup>319</sup> The leading case in this regard is *Unocal Corporation v Mesa Petroleum* 493 A2d 946, extracted in Chapter 11. See also: *City Capital Associates v Interco Inc* 551 A2d 787 (Del Ch 1988); *Paramount Communications Inc v Time Incorporated* 1989 WL 79880 (Del Ch 1989); *Paramount Communications Inc v Time Incorporated* 571 A2d 1140 (Del, 1990); *Unitrin Inc v American General Corp* 651 A2d 1361 (Del, 1995); *Carmody v Toll Brothers, Inc* 723 A2d 1180 (Del Ch 1998).

possible to imagine in the abstract many types of takeover defence, often with exotic names, that boards *could* deploy, on closer inspection many of these ‘defence types’ are unavailable to UK boards without first asking the shareholders for approval to use them. The fear and unequivocal opposition that talk of ‘takeover defences’ engenders in UK corporate regulatory and academic circles is often based upon the assumption that many of the infamous US defences – for example, the poison pill defence – would be available to a board of a UK target in the same way as they are in relation to a Delaware target company. This, as we shall see below, is incorrect.

We consider below the three primary defence types: *poison pills*; *restructuring defences*; *operational business decisions that have a defensive impact*. For clarity’s sake note that this extract considers the nature of these defensive types and their formal availability under UK company law – it does not consider the affect of the Takeover Code on such defences, which we consider below; nor does it consider how the use of such defences to defend against a takeover bid would comply with the directors’ duty to use corporate powers for the purposes for which they are conferred.<sup>320</sup>

## **D. Kershaw ‘The Illusion of Importance: Reconsidering the UK’s Takeover Defence Prohibition’ (2007) 56 *International and Comparative Law Quarterly* 267**

### **1. Shareholder Rights Plans: Poison Pills**

The most important type of board controlled US takeover defence is a shareholder rights plan. This defence involves warrants [which are options] issued by the target company to existing shareholders to purchase shares in the target company (flip-in plan) or in the bidder should a successful bidder merge with the target (flip-over plan).<sup>321</sup> These are the infamous poison pill<sup>322</sup> defences. They are put in place without shareholder approval by the issuance of the warrants as an interim dividend. The rights attached to these warrants are set out in a shareholder rights plan adopted by the board. The warrants are attached to the shares and transferred with the shares prior to a triggering event. The warrants have no economic value until triggered by a hostile bidder. If such a bidder crosses a specified ownership threshold, which is typically between 10–20% of target’s outstanding voting shares, *without* obtaining target board approval then the warrants give the existing shareholders (excluding the bidder) the right to purchase voting equity at, usually, a 50% discount. The effect of the pill if triggered is to significantly dilute the bidder’s existing shareholding in the target (flip-in plan) or the shareholders of the bidder itself following a subsequent merger (flip-over plan), resulting in a substantial transfer in value to existing target shareholders. Accordingly, no bidder would ever... [swallow] a pill. The shareholder rights plan provides that the board has the right to redeem the warrants. Until the board does so the takeover offer will not be able to proceed. Importantly, in most US states a pill can be adopted at any time without the requirement to obtain shareholder approval even after a

<sup>320</sup> In relation to which see Chapter 11.

<sup>321</sup> For a more detailed explanation of flip-in and flip over pills as well as a review of the initial approval of these devices by the Delaware Courts see J.P. Lowry, ‘Poison Pills’ in US Corporations – A Re-Examination’ (1992) *Journal of Business Law* 337.

<sup>322</sup> The term poison pill is sometimes used in UK debates as a general term for takeover defences, see, B. Clarke, ‘Regulating Poison Pill Devices’ (2004) 4 *Journal of Corporate Law Studies* 51. This article adopts the US approach to this terminology where poison pill is used exclusively to refer to shareholder rights plans.

bidder has announced its intention to commence an offer.<sup>323</sup> Variations on the redemption provisions, that are not valid in all states, include provisions that prevent redemption for a time period following the announcement of the bid (a no-hand pill) and continuing director provisions that allow only the board members that held office at the time the pill was adopted to redeem the pill (dead-hand pill)...<sup>324</sup>

Poison pills would be theoretically possible under UK company law. Boards of directors of companies are usually authorised to make interim dividends.<sup>325</sup> A warrant could be issued to all shareholders of the company as an interim dividend. As with a US poison pill, the rights attached to those warrants would be set out in a shareholder rights plan. However, in order to issue such warrants the shareholders in general meeting would have to provide the board with authority to grant the warrants.<sup>326</sup> In contrast to the United States, therefore, the pill would only be available with pre- or post bid shareholder approval. [As we have seen in Chapter 17, companies typically have rolling and substantial grants of authority to allot shares or to grant rights to subscribe for shares. However, these rolling grants are not typically significant enough to grant an option to every existing holder of the company's shares.]<sup>327</sup>

An additional problem with regard to the availability [of a poison pill in the UK for listed companies] arises from the terms of the United Kingdom Listing Authority's (UKLA) Listing Principle 5 which provides that for listed companies holders of the same class of shares be treated 'equally in respect of the rights attaching to such' shares.<sup>328</sup> Following a triggering event the bidder would not be able to exercise the right to purchase shares at a discount. If the bidder was allowed to do so it would vitiate the defensive impact of the pill as there would be no bidder value-dilution. Arguably, this discriminates against the bidder. The strong case that a pill *does not* amount to a violation of the equal treatment principle would be as follows: the warrant provides a contingent right which is applicable to all shareholders equally; should a bidder-shareholder not comply with the conditions of that warrant it would not be exercisable; the inability of the bidder to exercise any warrant rights stems not from shareholder

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<sup>323</sup> *Unitrin v American General Corp* 651 A2d 1361 (Del, 1995).

<sup>324</sup> No-hand and dead hand pills are not permitted in Delaware (see *Carmody v Toll Bros Inc* 723 A2d 1180 (Del, 1998); *Quickturn Design Sys Inc v Shapiro* 721 A2d 1281 (Del, 1998)), however, dead-hand pills have been approved in Georgia (*Invacare Corp v Healthdyne Tech* 968 F Supp 1678 (ND Georgia, 1997)) and no-hand pills have been approved in Pennsylvania (*AMP v Allied Signal No 98-4405* LEXIS 15617 (Pennsylvania, 1998)).

<sup>325</sup> The Model Articles for Public Company provides for interim dividends in Article 70(1).

<sup>326</sup> Section 551(1)(b) of the Companies Act 2006 requires that the board is authorized by the shareholders to 'grant rights to subscribe for, or to convert any security into, shares in the company'.

<sup>327</sup> Note that no waiver of pre-emption rights is required as the options are issued to the existing shareholders.

<sup>328</sup> UKLA Listing Rule 7.2.1, Principle 5.

rights discrimination but from the bidder's own failure to comply with the warrant's conditionality...

## [2] Restructuring Defences

A restructuring defence, which generally involves both a distribution to shareholders through an extraordinary dividend or share buy-back coupled with, and often funded by, either a placement of a block of shares with a friendly third party or a substantial increase in the company's leverage. The restructuring response is likely to depend on the nature of the bidder... A private equity bidder, will [see scope for considerable value in restructuring the target company's leverage (financial engineering)]. If, to the extent it is possible to do so, prior to the completion of the bid the... [target company changes its financial structure in the same way as one would expect a successful private equity bidder to, then all the value from financial engineering is transferred to the target shareholders]. However, if the bidder is an industrial cash or equity bidder... [then the target company's] restructuring is likely to focus on preventing the bidder from obtaining effective control. The recent proposed defensive response by the Luxembourg based steel company Arcelor following the hostile approach made by Mittal Steel is a simple example of the latter type of restructuring. The defensive proposal involved issuing shares to a friendly third-party, Severstal, amounting to 32% of the company's outstanding shares. The company also proposed to effect a share buy back which would have increased Severstal's stake in the company to 38%.<sup>329</sup> An equity restructuring defence is dependent on the company's ability to find and to be permitted to make an issue of shares to a friendly third-party. A debt restructuring defence is dependent on the company being sufficiently cash rich to service a substantial increase in debt and being permitted to make a very large distribution.

There is much less scope for carrying out restructuring defences in the UK than in the United States. Taking Delaware as the US comparator, if the company has sufficient authorized share capital the board has the power to issue a substantial block of shares to a friendly third party. No shareholder approval is required.<sup>330</sup> However, if the company is listed on the New York Stock Exchange and the share issue amounts to more than 20% of the outstanding voting shares of the company then shareholder approval is required.<sup>331</sup> Corporation statutes do not impose mandatory pre-emption rights and, although companies may at their option provide pre-emption rights, such provision would be unusual in US publicly traded companies.<sup>332</sup> Delaware companies have considerable flexibility to make large interim dividends provided that the company was not insolvent prior to, or as a result of, the dividend.<sup>333</sup> Companies may make dividends

<sup>329</sup> See 'Doubts on Arcelor's bear-hug strategy. Now the Luxembourg company faces governance issues' *Financial Times* (31 May 2006).

<sup>330</sup> Section 161 Delaware General Corporation Law (DGCL).

<sup>331</sup> New York Stock Exchange Listing Manual, para 312.02(c).

<sup>332</sup> B. Black and J.C. Coffee, 'Britannia: Institutional Investor Behaviour Under Limited Regulation' (1994) 92 *Michigan Law Review* 1997.

<sup>333</sup> Delaware Fraudulent Conveyance Act (Delaware Code, Title 6, subtitle II, Chapter 13, section 1305).

out of surplus,<sup>334</sup> which could include capital received for prior issues of shares in excess of the par value of those shares.<sup>335</sup> Nimble dividends out of the most recent year's profits may be made even though the company's cumulative losses exceed its profits.<sup>336</sup> Directors are authorised to repurchase shares provided that it does not impair the capital of the company.<sup>337</sup> No shareholder approval is required. All repurchased shares may be retained as treasury shares unless retired and may be resold to a third party.

[Under UK company law] UK companies face considerable restrictions in issuing shares to friendly third parties without post-bid shareholder approval.<sup>338</sup> Pursuant to current UK law, a board of directors can only issue shares to a third party if... the shareholders have granted authority to allot the shares<sup>339</sup> and, if the shares are issued for cash consideration, the shareholders have disapplied their statutorily imposed mandatory pre-emption rights.<sup>340</sup> Public companies generally seek annual resolutions that grant authority to allot shares. Such a grant of authority usually specifies the type of share, for example, ordinary shares and may be conditional or unconditional.<sup>341</sup> Even assuming a substantial and rolling grant of authority to allot shares,<sup>342</sup> it is clear that institutional shareholders value their pre-emption rights and although they are willing to grant a waiver of pre-emption rights for issuances of up to 5% of outstanding shares each year, which should not exceed more than 7.5% in any three year rolling period, they look dimly upon and will oppose more extensive waivers.<sup>343</sup> Although the recent

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<sup>334</sup> DGCL, section 170(a).

<sup>335</sup> DGCL, section 154.

<sup>336</sup> DGCL, section 170.

<sup>337</sup> DGCL, section 160. Capital here refers to the stated capital of the company which in many cases will only be the aggregate par value of the issued shares. If net assets post-repurchase are less than stated capital, capital will be impaired (B. Manning and J.J. Hanks, Jr, *Legal Capital* (3rd edn), 34).

<sup>338</sup> See generally Chapter 17.

<sup>339</sup> Sections 549–551 CA 2006. See G. Barboutis, 'Takeover Defence Tactics II: Specific Defensive Devices' (1999) 20 *Company Lawyer* 40 discussing, among others, authority to allot and pre-emption rights in relation to share issues as a defence tactic.

<sup>340</sup> Sections 561, 570, 571 CA 2006.

<sup>341</sup> Section 551 CA 2006

<sup>342</sup> See, for example, Vodafone Plc obtained at its AGM in July 2006 authority to allot 9,000,000,000 ordinary shares amounting to 14.9% of the capital of the company. See further Chapter 17, 660-662.

<sup>343</sup> Pre-emption Group, *Statement of Principles*, principles 8 and 10.



introduction of treasury shares may provide some companies with additional flexibility, the pre-emption regime applies to these shares as well.<sup>344</sup> In theory UK boards have some scope to avoid these restrictions as pre-emption rights are only applicable if the share issue is for cash only and contains no in-kind consideration.<sup>345</sup> Even an insignificant in-kind component would result in the avoidance of the pre-emption right regime. However, given that UK institutional investors value pre-emption rights any attempt by companies faced with a control threat to avoid pre-emption rights by combined cash and in-kind consideration would most likely result in conditions being placed upon future grants of authority to allot shares that would prevent any other non pre-emptive defensive issues.<sup>346</sup>

On the distribution side, UK regulation is again more restrictive.<sup>347</sup> To be able to make a substantial interim dividend UK public companies must comply with the net-profits test which requires that total cumulative realised profits exceed total cumulative realised losses by the amount of the dividend<sup>348</sup> and that net-assets exceed, amongst others, share capital and any share premium by the amount of the dividend.<sup>349</sup> A restructuring defence which involves a substantial distribution will, therefore, only be available to companies who have a very healthy balance sheet. Any attempt to alter the balance of control by making the distribution through a share repurchase is not as readily available to boards of UK companies as boards are not authorised to make such repurchases without shareholder approval.<sup>350</sup>

### **[3] Business Decisions with a Defensive Impact**

This category of defence involves business decisions that may have been taken because of their defensive impact but which can also be characterized as business decisions which were taken on the basis of the decision's business merits rather than its defensive impact. Post-bid this could include the sale of a key business asset or division, which is colloquially known as a 'crown jewels' defence, as the bidder would not be interested in the company without this asset...

A listed company board's freedom to sell all or a substantial stake in one of the company's important assets or divisions is constrained by the Listing Rules' regulation of Significant Transactions.<sup>351</sup> Pursuant to Listing Rule 10.5, if the transaction amounts

<sup>344</sup> Section 560(2)(b) and 573 CA 2006.

<sup>345</sup> Section 565 CA 2006.

<sup>346</sup> Section 551(2) CA 2006 provides that any authority to allot 'may be conditional or subject to conditions'.

<sup>347</sup> See generally Chapter 19.

<sup>348</sup> Section 830 CA 2006.

<sup>349</sup> Section 831 CA 2006.

<sup>350</sup> Section 694 CA 2006; section 701 CA 2006.

<sup>351</sup> See generally Chapter 6.

to 25% of the target's gross assets, or the profits of the assets represent 25% of the profits of the target, or the consideration is 25% of the target's market capitalisation,<sup>352</sup> then the transaction is classified by the Listing Rules as a Class 1 transaction which must be conditional upon, and cannot be carried out, without shareholder approval.<sup>353</sup> This contrasts with Delaware law where shareholder approval is required for a disposal only when it amounts to the sale of 'all or substantially all' of the company's assets.<sup>354</sup>

We see from the above extract that in the UK *even if* the Takeover Code was silent about takeover defences, which as we shall see below *it is not*, there is in fact very limited scope for the board of a listed company to use a takeover defence without having first to ask, contemporaneously, the existing shareholders for their approval to do so. That is not, however, to say that there is no availability. In theory, a target board could: sell important assets provided that the significant transaction rules are not invoked and the sale of any asset does not damage other aspects of the target's business; increase leverage and issue a large interim dividend provided it has sufficient distributable profits; and, depending on the shareholders' ex-ante allotment approval and pre-emption right waivers, be able to issue a significant block of shares to third parties.

Note, further, that even in relation to the limited availability of corporate actions that would not require contemporaneous shareholder approval a very strong argument exists that such actions would not be compliant with the target board's duties and most likely, therefore, unenforceable unless the shareholders had *either ex ante or contemporaneously* approved of the use of such powers. For a discussion of directors' duties in this regard see Chapter 11: *Regulating Discretion II: Using Corporate Powers for Proper Purposes*. We observed in Chapter 11 that the better view of the existing law is that corporate powers cannot be used to interfere with the shareholders' basic constitutional right to decide whether or not to accept an offer – *even if* the board have very good reasons for so doing – *unless* the shareholders approve of the use of such powers – *either ex-ante or contemporaneously*.

### 3 The Takeover Code's non-frustration rule

As we saw in the extract from Armour and Skeel above, the Takeover Code and its predecessor, the Notes on the Amalgamation of Business, represented a regulatory response to what was perceived to be the inappropriate use by target boards of the power to issue shares to deter unsolicited bidders.<sup>355</sup> The Takeover Code succeeded where the Notes on the Amalgamation of Business failed in putting a stop to this type of target board activity. It did so by introducing what is commonly known as the non-frustration rule, which today is set out in General Principle 3 and Rule 21.1 of the Takeover Code. This rule prevents target boards from engaging in any activity that would frustrate an actual or imminent bid without obtaining

<sup>352</sup> UKLA, Listing Rules, LR 10 (Significant Transactions), Annex 1 (the Class Tests).

<sup>353</sup> These provisions also regulate the issue of shares by a subsidiary that represents 25% of the gross assets or profits of the target group, if the effect of such an issue of shares is 'equivalent to the disposal of 25% of the group' (LR 10.2.8).

<sup>354</sup> Section 271(a) DGCL.

<sup>355</sup> Note that today the requirements to obtain authority to allot and pre-emption right waivers may have prevented the issue of shares in the British Aluminium and Metal Industries cases outlined in the extract from Armour and Skeel in Part B section I above. Furthermore, although these cases were not litigated there is a strong case that the use of these powers was not duty compliant.

shareholder approval for such actions, *prior to taking such actions*. Rule 21.1 provides as follows.

***Takeover Code – Rule 21.1 When shareholders' consent is required***

During the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be imminent, the board must not, without the approval of the shareholders in general meeting:

(a) take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits; or

(b) (i) issue any authorised but unissued shares or transfer or sell, or agree to transfer or sell, any shares out of treasury;

(ii) issue or grant options in respect of any unissued shares;

(iii) create or issue, or permit the creation or issue of, any securities carrying rights of conversion into or subscription for shares;

(iv) sell, dispose of or acquire, or agree to sell, dispose of or acquire, assets of a material amount; or

(v) enter into contracts otherwise than in the ordinary course of business.

The Panel must be consulted in advance if there is any doubt as to whether any proposed action may fall within this Rule.

The notice convening any relevant meeting of shareholders must include information about the offer or anticipated offer.

Where it is felt that:

(A) the proposed action is in pursuance of a contract entered into earlier or another pre-existing obligation; or

(B) a decision to take the proposed action had been taken before the beginning of the period referred to above which:

(i) has been partly or fully implemented before the beginning of that period; or

(ii) has not been partly or fully implemented before the beginning of that period but is in the ordinary course of business,

the Panel must be consulted and its consent to proceed without a shareholders' meeting obtained.

***NOTES ON RULE 21.1***

***1. Consent by the offeror***

*Where the Rule would otherwise apply, it will nonetheless normally be waived by the Panel if this is acceptable to the offeror.*

...

***3. Interim dividends***

*The declaration and payment of an interim dividend by the offeree company, otherwise than in the normal course, during an offer period may in certain circumstances be contrary to General Principle 3 and this Rule in that it could effectively frustrate an offer. Offeree companies and their advisers must, therefore, consult the Panel in advance.*

...

*6. Service contracts*

*The Panel will regard amending or entering into a service contract with, or creating or varying the terms of employment of, a director as entering into a contract 'otherwise than in the ordinary course of business' for the purpose of this Rule if the new or amended contract or terms constitute an abnormal increase in the emoluments or a significant improvement in the terms of service.*

...

*10. Shares carrying more than 50% of the voting rights*

*The Panel will normally waive the requirement for a general meeting under this Rule where the holders of shares carrying more than 50% of the voting rights state in writing that they approve the action proposed and would vote in favour of any resolution to that effect proposed at a general meeting.*

Rule 21.1(a) sets forth a principle preventing the board from acting to frustrate a bid without shareholder approval or, in limited circumstances, Panel consent. Sub-Rule (b) and the Notes to the Rule provide a *non-exclusive* list of types of corporate action that are prohibited during the course of a bid in the absence of contemporaneous shareholder approval. The board cannot: authorize the issuing of shares or options to buy shares; agree to sell material assets or enter into non-ordinary course transactions; or issue non-ordinary course interim dividends. Importantly, these specific prohibitions are not subject to any 'state of mind' qualification – that they are taken for a frustrating purpose. Rather they are, subject to Panel or shareholder consent, absolute prohibitions.

If the board wishes to take any of the specified steps or other steps that may prevent the shareholders deciding on the merits of the bid, shareholder consent must be obtained. Shareholder consent must be given after the bid has been announced or becomes imminent; shareholder approval prior to any bid becoming a possibility – even explicit *ex-ante* approval to allow the board to use all powers to frustrate a bid – would *not* satisfy the requirements of Rule 21. Accordingly, even where prior to a bid target shareholders have both waived their pre-emption rights and provided authority to allot a substantial block of shares or options to buy shares the board cannot, without contemporaneous shareholder approval or Panel consent, issue those shares. Panel approval will rarely be granted unless the *bidder* consents to the action<sup>356</sup> or in lieu of a general meeting shareholders owning 50% of the voting shares inform the Panel in writing that they would vote in favour of taking the action in question.<sup>357</sup>

An important question with regard to shareholder approval of defensive action in accordance with Rule 21 is how often in practice do boards of target companies request approval where the purpose of taking the corporate action is to frustrate the bid or create additional bargaining power to get a superior offer? The answer to this question is: never. The reason for this is that if shareholders are going to approve the use of takeover defences, a majority is likely to reject the bid and, therefore, it does not make any sense to ask for approval. It may be the case that a majority of the non-bidder-affiliated shareholders would oppose the bid and would vote in favour of using takeover defences; however, the shareholder approval requirement applies to all shareholders and does not exclude the bidder from voting the shares held by the bidder or parties acting in concert with him.

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<sup>356</sup> Takeover Code, Note 1 to Rule 21.1.

<sup>357</sup> Takeover Code, Note 10 to Rule 21.1.

## 4 Company law versus the non-frustration rule

We have seen from our analysis in B.IV.2 and from our analysis of the proper purpose doctrine in Chapter 11 that, even without the Takeover Code's non-frustration rule, there are very significant limitations on the formal availability of, and scope for boards of target companies to use, corporate powers for defensive purposes. However, there remains an important difference between UK company law's takeover defence regulation and the Takeover Code's non-frustration rule. This difference is that under the company law settlement it is open to shareholders to give boards of directors advanced approval to use the defences available *should* a bid arise, without having to come back to the shareholders for contemporaneous approval once the bid is commenced or becomes imminent. Pursuant to UK company law, shareholders can pre-commit to give the board defensive power even if when they are aware that these powers may be used by the board for self-serving rather than shareholder-regarding reasons. In theory, shareholders may elect to do this because in their collective view the advantages identified above outweigh the disadvantage that directors may abuse these powers. The Code's non-frustration rule prevents shareholders from making this election. The extract below argues that there is some comparative evidence that some shareholders would make this election and, if that is the case, this removal of contractual freedom by the Takeover Code requires a justification. The extract below explores possible justifications.

**D. Kershaw 'The Illusion of Importance: Reconsidering the UK's Takeover Defence Prohibition' (2007) 56 *International and Comparative Law Quarterly* 267**

Recent US evidence that the large majority of companies going public have potent complementary defences suggests that, given the option, sophisticated UK shareholders, such as private equity investors, who control a company prior to its initial public offering (IPO) would elect to make takeover defences available to the board. Whilst in the US institutional investors are vocal and active in their opposition to the mid-stream adoption of takeover defences through [a constitutional] amendment and the adoption of poison pills without shareholder approval,<sup>358</sup> they are involved in both the buy and sell side<sup>359</sup> of IPOs by companies with constitutions which provide for staggered boards and prevent shareholders from calling a special meeting or acting by consent. Of the 6000 US companies going public between 1987 and 1999 50% had staggered boards. [The most potent of takeover defences is the poison pill combined with a staggered or classified board. The reason for this as the way to defeat a poison

<sup>358</sup> Klausner summarizes research by the Investor Responsibility Research Center (Investor Responsibility Research Center, *Voting by Institutional Investors on Corporate Governance Issues* 5 (2001)) regarding US institutional investor voting practices as follows: '59% [of the survey respondents] consistently vote against management proposals to adopt classified [staggered] boards, and 65% vote in favor of shareholder proposals to repeal classified boards. Institutions oppose management control over poison pills as well, with 72% of survey respondents voting in favor of shareholder proposals that ask management to submit pills to shareholder vote before adoption', M Klausner, 'Institutional Investors, Private Equity and Anti-takeover Protection at the IPO Stage' (2003) 152 *University of Pennsylvania Law Review* 755, 760. He also notes that the institutional investor opposition to the mid-stream adoption of staggered boards has meant that management realizes that 'there is no point in even asking shareholders to support a [staggered] board' (758). Note also that unless there is a provision in the certificate of incorporation providing otherwise boards of Delaware companies can put in place poison pills without shareholder approval either before or after a bid has commenced (see *Unitrin Inc. v American General Corp* 651 A2d 1361 (Del, 1995)).

<sup>359</sup> For example, through their investments in private equity partnerships.

pill is to launch a proxy contest to remove the incumbent board and replace them with a bidder friendly set of directors who then proceed to withdraw the pill. This is not possible if the company has a staggered/classified board where the directors can only be removed for cause.<sup>360</sup> However, of those going public in 1999 82% had staggered boards.<sup>361</sup> In 1998 51.2% of companies going public prevented shareholders from calling interim meetings.<sup>362</sup>

Much hand-wringing has taken place in US corporate academic circles trying to explain this phenomenon.<sup>363</sup> Is this evidence that potent defences are value maximizing or is the price of the shares subject to a discount to take account of the negative value effects of these defences?<sup>364</sup> What is clear, however, is that providing companies with defences is the preference of sophisticated shareholders that retain a significant stake in the company. Whilst non-shareholder value explanations of this have been proffered<sup>365</sup> one cannot discount the possibility that in some cases owners want to protect the company from takeover to ensure that their remaining stake in the company is not cashed out by a future bidder who offers a premium that does not reflect the company's long term value. Whether or not as an empirical matter this turns out to be the case is irrelevant to the shareholders' view and preference at the time of the IPO. Any prohibition of shareholders' contractual expression of such preferences requires a persuasive rationale.<sup>366</sup> This section evaluates the available rationales.

#### **A. Post-bid Votes and Shareholder Sovereignty**

Proponents of the non-frustration principle could argue that it does not foreclose using an available defence as any such defence can be implemented with post-bid shareholder approval. This is unpersuasive. Requiring post-bid rather than pre-bid approval can alter the effectiveness of the defence. With an asset-sale defence, for example, in order for the defence to be credible the target must be able to negotiate a sale with a third-party interested in those assets. Carrying out legal and financial due diligence on the assets as well as negotiating their sale can be very costly. There are also reputation costs for a third-party purchaser who fails to complete the purchase. Any third-party

<sup>360</sup> On staggered/classified board in Delaware corporate law see Chapter 6.

<sup>361</sup> Klausner, above fn 358, 763–4.

<sup>362</sup> Note, however, that the prohibition on calling an interim meeting is defensively less important when directors can only be removed with cause, which is normally the case when the company has a staggered board.

<sup>363</sup> See Klausner, above fn 358, 766–84.

<sup>364</sup> Debevoise & Plimpton's *Private Equity Report* (2003), 3 notes that 'underwriters have frequently advised that including a normal set of shark repellents – including a poison pill – will not harm the marketability of the IPO shares'.

<sup>365</sup> See Klausner, above fn 358, 766–84.

<sup>366</sup> This rationale demand also applies to the mandatory background rule of UK company law analysed in this article, however, the focus of this article remains on rule 21.

approached to consider the purchase of such assets will be wary of incurring those costs when the target may well be using the third-party simply to extract a higher premium from the bidder. Concern about the costs of an unsuccessful transaction will be heightened if a shareholder vote could veto the sale. A potential third-party purchaser will be aware that even if the asset sale offers better value for the particular asset, shareholders may still prefer to exit their entire investment. Post-bid shareholder approval for an asset sale may well, therefore, undermine the asset sale defence. Accordingly, a post-bid shareholder approval process does not provide a rationale for removing pre-bid approval of a director controlled post-bid asset-sale defence.

Proponents of the non-frustration principle view the principle as the logical outcome of a commitment to shareholder sovereignty: shareholders decide whether to sell their shares or whether or not to approve proposed defensive action. As the Winter Report puts it: 'shareholders should be able to decide for themselves'.<sup>367</sup> This is misleading. Shareholders may rationally choose to constrain future shareholder rights by providing for a different balance of power between the board and the shareholders. Posit a small shareholder group who own and actively control a close company. The shareholders elect to take the company public and realise some of their capital gains but intend to maintain a substantial holding in the company and to continue to be operationally active. They are concerned that new shareholders, no matter how sophisticated, will not appreciate the long term value of the company when faced with a well timed premium offer and realise that if such future shareholders are inclined to accept an offer then they will not authorize post-bid defensive action. A rational shareholder group with this concern would provide the board with as much defensive capability as English law allows. If this choice is not available because it is blocked by the non-frustration principle shareholder sovereignty is undermined. In contrast, the sovereignty of shareholders who purchase shares in a company where post-bid defensive action is authorised ex-ante is unaffected if their opportunity to accept or reject a bid is inhibited by board action; the price they paid took account of this risk.

## **B. The Collective Action Problem**

A second rationale for foreclosing this defensive flexibility is a paternalistic one based around the potential for management to exploit the collective action problem. The argument is that if this option is made available then inactive shareholders who have poor financial incentives to pay attention to the company's activities, including amending its constitution, may well approve defensive flexibility without giving adequate consideration to its potential negative effects during a possible future takeover bid. This contrasts with an approval request during an actual bid, where an offer is likely to ignite shareholders' attention to the actual effects of a proposed defence. In the context of takeover defences this is a weak argument. Even though institutional shareholders may not have large enough holdings to be hands-on monitors of corporate action it is clear that in relation to what are regarded as key governance or value issues they actively mould corporate action.<sup>368</sup> The most obvious example of this behaviour in the UK is the Pre-emption Group that informally and effectively restricts pre-emption right waivers.<sup>369</sup> Evidence from the US also shows that once aware of the apparent

<sup>367</sup> See fn 316 above.

<sup>368</sup> See fn 358 and generally Chapter 6.

<sup>369</sup> Generally on the Pre-emption Group see <http://www.pre-emptiongroup.org.uk/>. The Pre-emption Group's Principles provide for routine institutional investor support for the disapplication of pre-emption rights *provided that* the annual disapplication does not

negative implications of takeover defences institutional shareholders can act to inhibit them. Witness, for example, the inability of companies without staggered boards to try and obtain shareholder approval for an amendment to the constitution introducing one. Institutional shareholder opposition has resulted in a sharp decline in the number of companies requesting such approval.<sup>370</sup> Given the widespread sense amongst UK investor circles that takeover defences are value destructive, one would expect UK institutional shareholders to be similarly circumspect. Accordingly, even if available, defensive mid-stream constitutional amendments are not subject to a collective action problem.

There is, however, considerable scope for introducing such defences at the IPO stage. As noted above, recent US evidence shows that most companies going public... [provide for potent defensive capability by adopting] staggered boards. However, purchasing shares in companies containing these defences does not generate the same paternalistic fervour as mid-stream constitutional amendments. Shares are a package of rights set out in the constitutional documents. If you do not like the rights you can elect not to buy or to buy at a discount to reflect what you consider to be the value-negative rights. However, you can have no complaint about buying the rights if, aware of the defences, you purchase without discount<sup>371</sup> or discount to take account of those rights. It could be the case that investors do not pay attention to or fail to take account of such rights: that is, in relation to certain provisions set out in companies' constitutions the capital markets are inefficient.<sup>372</sup> But even if this is the case it is not clear why the law should paternalistically protect investors who are perfectly capable of reading about and understanding such rights at the time of purchase.

### C. Agency and Incompetence Costs

A third justification for Rule 21 foreclosing the limited defensive flexibility left open by English company law focuses on the effect that takeover defences have on the operation of the market for corporate control, and the role of the market for corporate control in restraining agency costs and what I shall call incompetence costs. Agency costs are the costs that shareholders bear as a result of the fact that managers' interests are not wholly aligned with shareholders' interests... Incompetence costs are the costs that shareholders bear as a result of poor management decisions untainted by self-interest. In theory the market for corporate control can check both types of costs... According to this theory, the more active the market for corporate control the less scope for agency costs and the lower the likelihood that incompetent management survives. Anything that gets in the way of the market for corporate control activity, such as takeover defences, necessarily increases the scope for unsanctioned agency and incompetence costs.

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amount to more than 5% of the ordinary share capital of the company or 7.5% in a three-year rolling period.

<sup>370</sup> See Chapter 17.

<sup>371</sup> See fn 358.

<sup>372</sup> Considering such a possibility see: R. Daines and M. Klausner, 'Do IPO Charters Maximze Firm Value? Antitakeover Defences in IPOs' (2002) 17 *Journal of law, Economics and Organization* 83, 113; Klausner, above fn 358, 780–2, in particular, fn 88.



In analysing this justification for the non-frustration principle we need to understand the extent to which there is an agency cost or an incompetence cost problem in the UK that is not controlled by other mechanisms: if these costs are already controlled then the market for corporate control will be less significant or even superfluous in this regard. Furthermore, we need to understand whether non-controlled agency or incompetence costs are likely to be of such magnitude that they trigger market for corporate control activity: do the agency or incompetence cost savings of replacing management exceed the transaction costs of taking the firm over?

In the UK the case has not been made that agency costs require the market for corporate control to keep them in check. UK executive remuneration has increased markedly over recent years and is increasingly reliant on performance based compensation.<sup>373</sup> This in itself may be indicative of self-interested executive action although their value itself is in most cases immaterial when compared to company value. As is well known, increasing performance based compensation may, however, be a more cost effective way of ensuring that corporate actions are not tainted with self-interest. The scope for management to act in their own interests apart from directly or indirectly increasing remuneration and perquisites is limited in the UK. A strict duty of loyalty creates limited scope for personal exploitation of opportunities that would be of interest to the company without [approval from the board or the shareholder body].<sup>374</sup> Whilst the directors can enter into pre-disclosed self-dealing transactions with the company and keep the proceeds therefrom,<sup>375</sup> if such transactions involve the sale or purchase of assets that are not de minimis they must be approved by the disinterested shareholder body.<sup>376</sup>

In relation to incompetence costs, there are two roles which the market for corporate control could play: first, improving competence; and second, replacing failing management. Fear of losing one's job will not enable an individual to exceed his capability constraint. However, individuals may fail to make the most of their ability for reasons that do not fit within the label of shirking. Incentives matter for getting the most out of management. There is, however, no reason to think that the abstract possibility of a takeover bid is more likely to maximise (within an individual's capacity constraint) competence than the more immediate financial incentives of performance related pay. With regard to replacing failing management, there is evidence that in the UK boards will act to replace failing management. This is particularly apparent in the most poorly managed companies.<sup>377</sup> The increasing independence of UK boards

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<sup>373</sup> See M.J. Conyon and G.V. Sadler, 'How Does US and UK CEO Pay Measure Up?' (2005), working paper on file with the author.

<sup>374</sup> See Chapter 14; *Bhullar v Bhullar* [2003] EWCA CIV 424. Section 175(5) of the Companies Act 2006 allows public companies to elect, through their constitutions, to empower the board to approve director exploitation of such opportunities.

<sup>375</sup> See Chapter 13; Sections 177 and 180 CA 2006.

<sup>376</sup> Listing Rule 11; Sections 190–195 CA 2006. See Chapter 13.

<sup>377</sup> M.J. Conyon and A. Florou, 'Top Executive Dismissal, Ownership and Corporate Performance' (2002) *London Business School Working Paper* (available at SSRN: <http://ssrn.com/abstract=304940>).

following recent amendments to the Combined Code should enhance such discipline.<sup>378</sup> However, if performance is not viewed as poor enough for the board to act or if the apparent independence of the board is subverted, there remains, in theory, an important role for the market for corporate control to play.

The moot question is whether existing agency and incompetence costs are significant enough to trigger takeover activity and, if they are, whether the control market in practice appears to be responsive to these costs. Recently Blainaid Clarke has argued that ‘most instances of self-dealing will not result in a significant enough discount in the company’s share price to justify the substantial takeover premium that normally prevails’.<sup>379</sup> This echoes earlier US work by John Coffee who concluded that ‘the level of efficiency is either “not extreme enough to justify the necessary premium or so extreme as to surpass the offeror’s level of risk aversion”’.<sup>380</sup> Empirical evidence in the UK is consistent with this position. Frank and Mayer’s study of 80 hostile bids in the UK between 1985–1986 found that there was ‘no evidence of either high bid premiums or poor pre-bid performance when takeovers involve managerial control changes’. They concluded that ‘the market for corporate control does not, therefore, function as a disciplinary device for poorly performing companies’.<sup>381</sup>

#### **D. Value Destruction**

If takeover defences destroy shareholder value then they externalise a cost on the economy as a whole. Their prohibition is then viewed as a justifiable intervention into the freedom of contract in the interests of maximizing social welfare. On the other hand, if takeover defences make a positive contribution to shareholder value then one would have to look elsewhere to rationalise their prohibition. The US debate pivots around value: those opposed to defences seek to demonstrate negative value implications; those in favour search for indications of value creation. In assessing the value implications of defences commentators have focused on: the reaction of capital markets to the adoption of defences; the effect of defences on takeover activity; the return on capital for rejected bids compared to the market as a whole; the operational performance of companies with takeover defences; and the premiums received by shareholders in companies with and without defences. [However the empirical literature provides no clear position on] the relationship between value and takeover defences: there is no majority position.

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<sup>378</sup> Combined Code (Financial Reporting Council, 2008).

<sup>379</sup> B. Clarke, ‘Articles 9 And 11 of The Takeover Directive (2004/25) And The Market For Corporate Control’ (2006) *Journal of Business Law* 355, 359.

<sup>380</sup> *Ibid*, 360 (J. Coffee, ‘Regulating the Market for Corporate Control: a Critical Assessment of the Tender Offer’s Role in Corporate Governance’ (1984) 84 *Columbia Law Review* 1145, 1202–3).

<sup>381</sup> J. Franks and C. Mayer, ‘Hostile Takeovers in the UK and the Correction of Managerial Failure’ (1996) 40 *Journal of Financial Economics* 163, 180.

John Coates has demonstrated that much of the empirical work on the value implications of takeover defences is deeply flawed.<sup>382</sup> In relation to event studies that attempt to isolate the value effects of poison pill adoption on a company's share price,<sup>383</sup> he concludes, amongst others: that the studies are inconsistent from study to study and inconsistent over time; suffer from methodological problems in identifying the data set; that earlier studies' negative value findings may be a function of markets misestimating the implications of what was then an innovative defence; that the studies fail to take account of the fact that a pill can be adopted at any time, so that a company without a pill is no different defensively (ignoring the interaction with other defences) than a company with a pill; and that the studies fail to take account of how pills interact with other defences. In relation to event studies of takeover defences included in the company's constitution he concludes that the results are mixed and that insignificant results predominate. More fundamentally, he observes that studying the value implications of these defences makes little sense in an environment that permits poison pills that thereby render these other defences of little consequence. In relation to pill and charter amendment event studies he concludes the problems he identifies 'reduce the value of prior event studies to the vicinity of zero'.<sup>384</sup> The 'principle mystery about event studies of takeover defences' he submits, is 'how researchers managed to find any results, or why anyone took those results seriously'.<sup>385</sup> In relation to studies of takeover premiums, he notes that the studies looking at the relationship between pill adoption and takeover premiums consistently demonstrate that those companies with pills obtain higher premiums in subsequent bids. This is usually explained by the increased negotiating power that such defences give the board. However, he argues that there is no necessary causal connection between the pill and the increased premium. The reason for this is that, as noted above, as a company can adopt a pill at any time there is, in pill terms, no difference between a company with a pill and one without a pill. In relation to market for corporate control activity, Coates' review of the evidence concludes that pills alone do not deter bids. More recent work supports this assessment.<sup>386</sup>

Some support for the position that defences destroy value is found in work looking at the effect of reorganization defences. Dann and DeAngelo in a survey of hostile takeovers between 1962–1983 found significant negative stock market returns at the time a defensive restructuring was announced.<sup>387</sup> One would not, however, wish to

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<sup>382</sup> J.C. Coates IV 'The Contestability of Corporate Control: A Critique of the Scientific Evidence' (1999) *Harvard John M. Olin Center for Law, Economics and Business Discussion Paper No. 265* (available at SSRN: <http://ssrn.com/abstract=173628>).

<sup>383</sup> *Ibid*, 11–29.

<sup>384</sup> *Ibid*, 38.

<sup>385</sup> *Ibid*, 69.

<sup>386</sup> R.A. Heron and E. Lie, 'On the Use of Poison Pills and Defensive Payouts by Takeover Targets' (2006) 79 *Journal of Business* 1783.

<sup>387</sup> L. Dann and H. DeAngelo, 'Corporate Financial Policy and Corporate Control' (1988) 20 *Journal of Financial Economics* 87.

place excessive weight on these findings. The sample was small and the time period for analysing the returns does not extend beyond the announcement date. Whilst the authors conclude that their findings are consistent with the entrenchment hypothesis they acknowledge that it is not the only possible explanation.<sup>388</sup> Others have argued that companies that adopt defences have poorer operating performance.<sup>389</sup> More recently, a study by Danielson and Karpoff found that 'operating performance generally improves during the five-year period following pill adoption' which is 'inconsistent with the view that pills degrade performance'.<sup>390</sup>

Subsequent work by Coates together with Bebchuk and Subramanian has looked at whether pills in combination with an effective staggered board (ESB)<sup>391</sup> can effectively repel takeover bids and what impact resistance has on shareholder value.<sup>392</sup> They conclude that the ESB-pill combination does increase the chances of companies remaining independent. In their sample of 92 hostile bids, 60% of the 45 companies with an ESB and a pill remained independent compared to 34% of targets without an ESB.<sup>393</sup> Furthermore, they concluded that the returns of the companies who remained independent as compared to companies sold to either the initial bidder or a third party bidder were 36% less in the short run (9 months) and 55% less in the long run (30 months).<sup>394</sup> Their conclusions, however, are not uncontroversial. Most importantly, opponents argue that the ESB-pill combination creates a powerful bargaining chip that results in increased returns in friendly deals which dwarf lower returns for shareholders in companies that deploy the defences to block a deal.<sup>395</sup> Bebchuk, Coates and Subramanian have attempted to counter this with limited empirical evidence that

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<sup>388</sup> *Ibid*, 114.

<sup>389</sup> G.A. Jarrell, J.A. Brickley, and J.A. Netter, 'The Market for Corporate Control: the Empirical Evidence Since 1980' (1988) *Journal of Economic Perspectives* 49. P.A. Gompers, J.L. Ishii, and A. Metrick, 'Corporate Governance and Equity Prices' (2001) NBER Working Paper No 8449.

<sup>390</sup> M.G. Danielson and J.M. Karpoff, 'Do Pills Poison Operating Performance' (2006) 12 *Journal of Corporate Finance* 536, 552.

<sup>391</sup> An effective staggered board is one that cannot be removed by unilateral shareholder action. For example, a staggered board would be ineffective if provided for by the by-laws, which can usually be amended by the board or by the shareholders acting alone (section 109 DGCL), rather than in the charter which requires board and shareholder approval (section 242(b) DGCL).

<sup>392</sup> L. Bebchuk, J. Coates IV, and G. Subramanian, 'The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy' (2002) 54 *Stanford Law Review* 887.

<sup>393</sup> *Ibid*, 930.

<sup>394</sup> *Ibid*, 936.

<sup>395</sup> For example, see M. Gordon, 'Takeover Defenses Work. Is That Such a Bad Thing?' (2002) 55 *Stanford Law Review* 819, 823, 837.

friendly deals with ESB-pill targets do not generate positive abnormal returns.<sup>396</sup> By the authors' admission this empirical rebuttal is tentative given the small sample size. More importantly, it is logically inconsistent:

'It seems an impossible feat of logic to argue, on the one hand, that ESBs represent "a serious impediment to the hostile bidder seeking to gain control over the [incumbent directors'] objections" and are "extremely potent as an antitakeover device", while at the same time arguing that, on the other hand, boards are unable to use this extremely potent force to extract a better price from any genuinely interested suitor.'<sup>397</sup>

Subramanian has attempted to rebut this argument arguing that in practice the scope for target management to deploy this bargaining power may be limited due to, for example, the existence of other similar purchase options for the bidder or the absence of plausible other buyers.<sup>398</sup> However, whilst Subramanian demonstrates that these case-contingent factors can affect the value range in which bargaining can take place, his analysis demonstrates necessarily that there will be cases in which the bargaining range is broad and where the ESB-Pill bargaining power can be deployed. The overall value implications of the ESB-Pill combination, therefore, remain unresolved.

The value debate in the United States, therefore, does not provide Rule 21 with a convincing existential rationale. It remains a moot point whether takeover defences generate or destroy shareholder value. More problematic for Rule 21 is that the limited US evidence of value destruction is either inapplicable or less relevant to the UK. Bebchuk, Coates and Subramanian's evidence that ESB-Pill combinations are value decreasing does not travel to the UK. In the UK staggered boards and with-cause removal of directors are not available which, as demonstrated above, substantially strips the pill of its potency. Evidence that reorganization defences are value decreasing should also be viewed as context specific. Several of the restructurings studied by Dann and DeAngelo would not be available in the UK without ex-post shareholder approval because they involved share issues and buy backs, and divestures and acquisitions that would have exceeded the UK's 25% threshold.<sup>399</sup> Furthermore, as noted above, the possible removal threat post-failed bid may well have been much lower in the US cases studied than it would have been in the UK due to the existence in the subject firms of staggered boards and with-cause removal. If, as Dann and DeAngelo suggest, entrenchment does explain the negative returns in the reorganization cases which they analyse, it is not clear that the different set of UK background rules would not control any entrenchment temptation. Indeed it is very plausible that in the UK legal environment any value decreasing entrenchment effects of takeover defences are neutralised by the mandatory set of background rules, allowing value-positive effects to dominate. Unfortunately this hypothesis is not testable so long as Rule 21 is in force.

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<sup>396</sup> L.A. Bebchuk, J.C. Coates, G. Subramanian 'The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants' (2002) 55 *Stanford Law Review* 855, 906-8.

<sup>397</sup> Gordon, above fn, 395, 824.

<sup>398</sup> See Subramanian, above fn 317, 641-66.

<sup>399</sup> See Dann and DeAngelo, above fn 387, 116-26.

## 5 Existing barriers to hostile takeovers and the break-through rule

UK company law provides companies with considerable flexibility to structure the control rights attached to their shares as they choose. Whilst typically an ordinary share may carry one vote per share, shares may be issued that carry multiple votes per share giving the holders of those shares control rights which are disproportionate to their economic interests in the company.<sup>400</sup> If such structures are in place they may represent barriers to control transactions that the majority of shareholders, with a majority economic interest, would wish to accept. If shareholders holding a minority economic interest have a control position because of multiple voting rights, no takeover offer will be made without agreement from those shareholders to sell their shares. Such structures may, therefore, create barriers to efficient control transactions, particularly, where it is not possible for a bidder to offer the holders of those shares a (sufficiently) superior offer<sup>401</sup> to take account of any private benefits of control<sup>402</sup> that the multiple voting rights give that shareholder. Similarly, barriers are present if a company's articles of association impose restrictions on sale transfers, such as the right to veto a share transfer or if they give particular shareholders rights to appoint a specific number of directors to the board.

In the UK it would be extremely rare for listed companies to have restrictions on share transfer<sup>403</sup> and unusual, although not unheard of, for such companies to have a shareholder who controls the company through shares carrying multiple voting rights. In other European countries, such as Sweden, such arrangements are more common.<sup>404</sup> The European Commission when drafting the Takeover Directive felt that such structures presented a significant barrier to efficient control transactions in Europe. Its controversial solution was the Takeover Directive's 'breakthrough rule', which is designed to 'break-through' these barriers to enable control transactions to proceed that otherwise could not. This involves suspending restrictions on the transfer of shares and restrictions on voting during the course of the offer and reducing multiple-voting rights to one vote per share in relation to shareholder decisions on defensive actions.<sup>405</sup> In addition, it enables a bidder who successfully obtains 75% of the shares which carry voting rights (regardless of how many voting rights) to break-through the control held by the multiple-voting rights shareholders, as in these circumstances such shares are demoted to one vote per share at the first general meeting following the takeover.<sup>406</sup> At such meeting the share and voting structure could be altered or a merger or scheme of arrangement could be approved.

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<sup>400</sup> See further Chapter, 17 pp 646–9.

<sup>401</sup> The offer for such shares, as a separate class of shares, would be a different but a comparable offer (*Takeover Code*, Rule 14).

<sup>402</sup> On the private benefits of control see Chapter 16, Introduction and footnote 308.

<sup>403</sup> Listing Rule 2.2.4 requires that listed shares are freely transferable although the FSA does have a discretion to grant a waiver in 'exceptional circumstances', which is rarely requested or granted.

<sup>404</sup> See generally Shearman & Sterling, *Report on the Proportionality Principle in the European Union* ([http://ec.europa.eu/internal\\_market/](http://ec.europa.eu/internal_market/)).

<sup>405</sup> Directive 2004/25/EC on Takeover Bids, Article 11(2) and (3).

<sup>406</sup> *Ibid*, Article 11(4).

However, as grand the ambitions and as innovative the design of the Takeover Directive's breakthrough rule, for the UK and the majority of EU jurisdictions it is of little practical interest. The reason for this is that, along with the non-frustration rule, the Takeover Directive makes the breakthrough rule optional.<sup>407</sup> Most jurisdictions, including the UK, have not opted for its automatic application.<sup>408</sup> However, the Directive requires that even where member states do not opt-in they must make the rule available for individual companies that wish to opt-in.<sup>409</sup> These rules are set forth in sections 966–9 of the 2006 Act. We shall not consider them in depth here. They represent an 'off the shelf' set of limitations *on* restrictions on share transfers and *on* control rights, whether voting or otherwise. It has always been open to companies to fashion rules that do what opting-in to the UK's breakthrough rules would do. Furthermore, in practice it is submitted that no companies will opt-in to these arrangements. If company shareholders require such arrangements, which most companies will not, it is likely that they will tailor them to their specific requirements.

### Questions and discussion:

1. What in your view is the most persuasive rationale for the non-frustration rule?
2. In your view does the common law or Rule 21 of the Takeover Code provide a more suitable settlement for UK company law?
3. Is the additional scope to use takeover defences that the common law offers, as compared to Rule 21, trivial?
4. Have developments in company law – including for example, changes to the rules on the allotment of shares and pre-emption rights, as well as increased clarity on the common law position on using corporate powers for takeover purposes – altered the company law context within which Rule 21 operates? In your view, has this changed context altered the need for Rule 21?
5. If the events which lead to the creation of the Takeover Panel happened in 2009, what steps would you expect to be taken by institutional shareholders? Would such events have led to the Takeover Panel and the non-frustration rule today?
6. 'Kershaw understates the importance of regulatory simplicity. For market participants it is good to know where one stands and the non-frustration rule makes this completely clear: no defensive action once a bid has commenced or is imminent, period. While the common law settlement may provide companies and shareholders with additional flexibility, this flexibility is not worth the price of additional deal uncertainty and delay that would be created by questions about the legitimacy of defensive action, which would have to be settled by the courts.' Discuss.
7. 'The non-frustration rule is, along with Rule 9, an important means of staking the parameters of the Takeover Panel's regulatory space. Without the non-frustration rule the role of courts would increase and an accommodation would have to be reached on issues of bid timetable where defensive action resulted in court challenge. The non-frustration rule ensures that the Takeover Panel have complete control over the regulation of control transactions.' Do you agree?

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<sup>407</sup> *Ibid*, Article 12(1).

<sup>408</sup> Note that the breakthrough rule has only been adopted by a minority of member states including, Estonia, Latvia and Lithuania.

<sup>409</sup> *Ibid*, Article 12(2).

### Further reading

- L. Bebchuk, 'The Case Against Board Veto in Corporate Takeovers' (2002) 69 *The University of Chicago Law Review* 973.
- M. Lipton, 'Corporate Governance in the Age of Finance Corporatism' (1987) 136 *University of Pennsylvania Law Review* 1 (Martin Lipton is a Senior Partner at Wachtell, Lipton, Rosen and Katz and creator of the poison pill).
- M. Klausner, 'Institutional Investors, Private Equity and Anti-takeover Protection at the IPO Stage' (2003) 152 *University of Pennsylvania Law Review* 755.
- R. Daines and M. Klausner, 'Do IPO Charters Maximize Firm Value? Antitakeover Defences in IPOs' (2002) 17 *Journal of Law, Economics and Organization* 83.
- L. Bebchuk, J. Coates IV, and G. Subramanian, 'The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy' (2002) 54 *Stanford Law Review* 887.
- M. Gordon, 'Takeover Defenses Work. Is That Such a Bad Thing?' (2002) 55 *Stanford Law Review* 819, 823, 837.
- B. Clarke, 'Articles 9 And 11 of The Takeover Directive (2004/25) And The Market For Corporate Control' (2006) *Journal of Business Law* 355.
- T.I. Ogowewo, 'Rationalising General Principle 7 of the City Code' (1997) 1 *Company Financial and Insolvency Law Review* 74.



# C: SCHEMES OF ARRANGEMENT AND MERGERS

## I Introduction

UK company law provides a comparatively idiosyncratic mechanism for implementing a control transaction by way of *effective* takeover, asset sale, or merger. This mechanism is known as a *scheme of arrangement*.<sup>410</sup> Using a scheme of arrangement to implement a control transaction is only one facet of what a scheme of arrangement can be used for. The scheme is an exceptionally flexible tool for restructuring a company, including: its share capital, the rights attached to different classes of shares and the rights of the company's creditors.<sup>411</sup> A core benefit of a scheme, whether used to effect a control transaction or some other form of shareholder or creditor restructuring, is that if it receives the required shareholder support and court sanction the scheme is imposed on all dissenting shareholders and creditors, as the case may be. Our concern here is, of course, with the scheme of arrangement as a mechanism for implementing a control transaction.

For initial context, consider the following ways in which a scheme can be used to effect a control transaction:

- A basic scheme of arrangement could be used to effect a takeover through the transfer of target company shares in exchange for newly issued shares from the bidder or even bidder company shares held by bidder shareholders.<sup>412</sup> As we shall see, using a scheme to effect such a control transaction provides greater certainty for the bidder that he will be able to get 100% control over the company.
- A common scheme of arrangement, which is a substitute for a contractual offer, is known as a *cancellation and reduction scheme*.<sup>413</sup> Here, via a scheme of arrangement, the existing shares in the company are cancelled in exchange for consideration from the bidder, which may be cash consideration from the bidder but could also be shares issued by the bidder. Once the shares are cancelled new shares are then issued to the bidder. The reserve that is created by the cancellation of the original shares is used to pay up in full the newly issued shares.<sup>414</sup> The advantage of this arrangement over a cash or share exchange contractual offer is that the existing shares are not transferred;

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<sup>410</sup> Many US states in fact adopted a similar mechanism in their corporate codes based, apparently, on the Companies Act. However, these provisions were not used by US companies. See note, 'Corporate Reconstructions by Arrangements with Shareholders or Creditors' (1949) 62 *Harvard Law Review* 468.

<sup>411</sup> See, for example, the facts in *Re M B Group plc* [1989] BCLC 672.

<sup>412</sup> See, for example, *In re Guardian Assurance Company* [1917] 1 Ch 431.

<sup>413</sup> See, example, the facts of *Re BTR Plc*, All England Official Transcripts (1997–2008).

<sup>414</sup> Typically the same number of new shares are issued as the number of shares cancelled so the company's legal capital is unaltered. See for example, the Signet Group Plc scheme of arrangement: <http://rd2008.signetgroupplc.com/sig67schemearrangement>.

rather they are cancelled and as a result the transaction does not attract stamp duty.<sup>415</sup> Note that as this transaction results in a reduction of capital the reduction of capital requirements must also be complied with.<sup>416</sup>

- A scheme can also be used to merge two or more companies or to transfer assets or divisions by operation of law. Consider, for example, a recent scheme entered into by Mytravel Group Plc which became insolvent in 2004. The business was restructured through a scheme of arrangement which implemented the following steps: (1) the transfer of assets and business divisions of the failed company to a newly formed company; (2) the assumption by the new company of some, but not all, of the liabilities of the failed company; and (3) the issue of the significant majority of shares in the new company to certain of the existing creditors of the failed company, although a small percentage of shares were also issued to the shareholders in the failed company.

Today the provisions providing for schemes of arrangement are set out in the Part 26 of the Companies Act 2006: *Arrangements and Reconstructions*. In this regard consider the following key provisions.

### **Section 895 CA 2006 Application of this Part**

(1) The provisions of this Part apply where a compromise or arrangement is proposed between a company and—

- (a) its creditors, or any class of them, or
- (b) its members, or any class of them.

(2) In this Part—

‘arrangement’ includes a reorganisation of the company’s share capital by the consolidation of shares of different classes or by the division of shares into shares of different classes, or by both of those methods...

### **Section 896 CA 2006 Court order for holding of meeting**

(1) The court may, on an application under this section, order a meeting of the creditors or class of creditors, or of the members of the company or class of members (as the case may be), to be summoned in such manner as the court directs.

(2) An application under this section may be made by—

- (a) the company,
- (b) any creditor or member of the company, or
- (c) if the company is being wound up or an administration order is in force in relation to it, the liquidator or administrator.

### **Section 897 CA 2006 Statement to be circulated or made available**

(1) Where a meeting is summoned under section 896—

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<sup>415</sup> Finance Act 1999, Schedule 13, paras 1–3 and section 112(3) Finance Act 1999 giving effect to the Schedule 13.

<sup>416</sup> See further Chapter 17. Note as the cancellation and reduction scheme does not involve a ‘payment to a shareholder of any paid-up capital’ (section 645(2) CA 2006) – the payment for the shares comes from the third party bidder – the creditor objection procedure (section 646 CA 2006) will not be required.

(a) every notice summoning the meeting that is sent to a creditor or member must be accompanied by a statement complying with this section, and  
(b) every notice summoning the meeting that is given by advertisement must either—  
(i) include such a statement, or  
(ii) state where and how creditors or members entitled to attend the meeting may obtain copies of such a statement.

(2) The statement must—

(a) explain the effect of the compromise or arrangement, and  
(b) in particular, state—  
(i) any material interests of the directors of the company (whether as directors or as members or as creditors of the company or otherwise), and  
(ii) the effect on those interests of the compromise or arrangement, in so far as it is different from the effect on the like interests of other persons.

(3) Where the compromise or arrangement affects the rights of debenture holders of the company, the statement must give the like explanation as respects the trustees of any deed for securing the issue of the debentures as it is required to give as respects the company's directors...

### **Section 898 CA 2006 Duty of directors and trustees to provide information**

(1) It is the duty of—

(a) any director of the company, and  
(b) any trustee for its debenture holders, to give notice to the company of such matters relating to himself as may be necessary for the purposes of section 897 (explanatory statement to be circulated or made available).

(2) Any person who makes default in complying with this section commits an offence.

### **Section 899 CA 2006 Court sanction for compromise or arrangement**

(1) If a majority in number representing 75% in value of the creditors or class of creditors or members or class of members (as the case may be), present and voting either in person or by proxy at the meeting summoned under section 896, agree a compromise or arrangement, the court may, on an application under this section, sanction the compromise or arrangement.

(2) An application under this section may be made by—

(a) the company,  
(b) any creditor or member of the company, or  
(c) if the company is being wound up or an administration order is in force in relation to it, the liquidator or administrator.

(3) A compromise or agreement sanctioned by the court is binding on—

(a) all creditors or the class of creditors or on the members or class of members (as the case may be), and  
(b) the company or, in the case of a company in the course of being wound up, the liquidator and contributories of the company.

(4) The court's order has no effect until a copy of it has been delivered to the registrar.

Part 26 applies to both 'compromises and arrangements' with creditors as well as with members. Accordingly, the scheme mechanism can be used to restructure a company's debt. Such schemes will not concern us in this chapter. We are only concerned here with shareholder schemes of arrangement used to effect control transactions.

The basic structure of a scheme of arrangement involves: (1) an application to court to summon a general meeting to consider the 'compromise or arrangement'; (2) the requisite approvals of the shareholders of the companies involved in the 'compromise or arrangement' are obtained at the court ordered general meetings; (3) following due approval, on application to the court, the court *may* then sanction the compromise or arrangement; and (4) the court order approving the scheme must be registered with the Companies Registrar – upon registration the scheme becomes effective.

Three questions flow from these steps: what amounts to a compromise or arrangement; what is the nature of the shareholder approval that must be obtained; and what factors will the court take into account in deciding whether or not to sanction the scheme of arrangement? We address each of these questions in turn.

## 1 What falls within the terms 'compromise' and 'arrangement'?

The term 'compromise' clearly suggests a disagreement or a dispute where both parties reach an agreement on a position that does not reflect their preferred position. The term is suitable where, for example, an agreement is reached between the company and its creditors where the creditors may be altering their claim on or relationship with the company. However, the term 'compromise' is ill suited to control transactions where the parties to the transaction have not compromised but rather reached an agreement that is viewed favourably by both of them. On a literal reading, the term 'arrangement' is clearly capable of encompassing such control transactions. However, an important question in understanding this term is whether the potentially broad meaning of the term 'arrangement' should be interpreted in light of the use of the term 'compromise' (*ejusdem generis*). Some early cases suggested that the term should be so read. In *Re General Motor Cab Co Ltd* Buckley LJ observed that "arrangement," no doubt, is a larger word than "compromise," but "arrangement" I think in that section must mean something analogous in some sense to "compromise."<sup>417</sup> This view, however, was not maintained. In *Re Guardian Assurance*, the subject company proposed a scheme of arrangement which involved the transfer of the shares in one company to the Guardian Assurance company in exchange for existing shares held by Guardian's shareholders. At first instance the court held that this did not amount to an arrangement for the purposes of the Act as the term 'arrangement' should be read in light of the term 'compromise' which 'embraces an agreement between two or more persons for the ascertainment of their rights when there is some question in controversy between them or some difficulty in the enforcement to the uttermost farthing of the rights of the claimant', and that for the proposed action to fall within the term 'arrangement' it must be 'analogous in some sense to compromise'. In reversing this judgment Cozens-Hardy LJ held that:

I think what is proposed to be done in perfect good faith, and for very good business reasons, is not a compromise, but is an arrangement proposed between a company and its members, using the words of section 120 [of the Companies (Consolidation) Act 1908] and that there is no necessity to put such a limitation upon those words as Younger J. felt bound to do. With the greatest possible respect to him, having carefully considered his very able judgment, I am unable to come to the same conclusion as he did.<sup>418</sup>

<sup>417</sup> [1913] 1 Ch 377. See also *Re Alabama, New Orleans, Texas, and Pacific Junction Ry Co* [1891] 1 Ch 213.

<sup>418</sup> *In re Guardian Assurance Company* [1917] 1 Ch 431.

While the courts have continued to take a broad view of the term 'arrangement'<sup>419</sup> subsequent courts have clarified that while the term is not subject to any parameters imposed by the term 'compromise' the term does require a form of exchange or 'give and take' between the company and the shareholders. An arrangement does not include actions that expropriate members' rights. In this regard consider the following case.

***Re NFU Development Trust Ltd* [1973] 1 All ER 135**

[The headnote to the case sets out the facts as follows:]

The NFU Development Trust Ltd was a company limited by guarantee without a share capital, its objects being generally to further, encourage and assist the farming community and in particular farmers engaged in the production of fatstock. The NFU Development Co Ltd was a member of the company. In addition there were about 94,000 other members all of whom were farmers, farming companies or retired farmers. The company's assets exceeded £3 million and its liabilities were less than £25,000. Members were elected by the board. Their only obligation was to pay an entrance fee of 25p and to contribute 5p should the company's assets be deficient. The articles provided that no dividends should be paid to members but that, on a winding-up, surplus assets would be divided among members in such proportion as the board might determine and in default of such determination equally between the members. Members had the right to elect members of nine area 'electoral colleges' each of which appointed a member of the board, other members of the board being appointed by the NFU Development Co Ltd and the farmers' unions. Every member had a right to vote at a general meeting of the company save that on a resolution to alter the memorandum or articles, to wind up the company or to remove or appoint a director, the NFU Development Co Ltd had three times the number of votes cast by all other members who voted. In order to reduce the expenses of administration the board proposed a scheme reducing the membership of the company to seven, one of the seven being the NFU Development Co Ltd, and depriving all other members of their membership. At the meeting directed by the court 1,439 votes were cast, seven in person and the remainder by proxy. 1,211 votes were cast in favour of the scheme and 228 against, a majority of almost 85 per cent. [The company petitioned for the court to sanction the scheme of arrangement. The dissenting shareholders objected to the court sanction of the proposal on the ground that it did not amount to an arrangement for the purposes of the Act.]

**Brightman J**

Counsel's second submission was that the terms of the scheme were such that it did not qualify as an arrangement within the meaning of [the Act]. The effect of the scheme would be that all the members of the company, except the NFU Development Co and such of the so-called new members as were not already members of the company, would be stripped of all their rights and receive in exchange no compensating benefit of any description, except the theoretical extinction of their contingent liability to contribute 5p in case of a winding-up; theoretical, because it is *de minimis* and has no significance in the context of a non-trading company with assets of £3,000,000 and liabilities which do not exceed £25,000. A member loses his right to attend the annual general meetings and other meetings of the company; his right to make his voice heard at meetings; his right to receive the board's annual report and the company's accounts; his right to question the use which the board makes or omits to make of the company's

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<sup>419</sup> See also *Re National Bank Ltd.* [1966] 1 WLR 819, and *Re Calgary and Edmonton Land Co Ltd (In Liquidation)* [1975] 1 WLR 355.

considerable financial resources; the right to vote on the remuneration of directors; the right to put himself forward for appointment to an area electoral college and thus acquire a say in the election of a director. Admittedly the rights of a member are very limited, and so it may be said that a member does not lose much under the scheme because he has not much to lose. Nor did he pay much for his membership rights in the first place – merely an entrance fee of 5s. Be that as it may, the company has become prosperous, no doubt as a result of the support which members gave to the company's marketing undertaking during the period that it traded, and the profit thereby made by the company. However little a member originally paid for his membership, and however small his effective stake in the company and his opportunity to control its operations, nevertheless he has rights and under the scheme he loses all. Counsel referred me to what was said in *Re Alabama, New Orleans, Texas and Pacific Junction Railway Co.* In that case debenture holders objected to a scheme which diminished their rights. The scheme was sanctioned by North J and his decision was upheld on appeal. In the course of his judgment Bowen LJ said ([1891] 1 Ch at 243):

'Then comes the more serious point, *whether* this is a compromise or arrangement which is within either the words of the section or within the true spirit of the legislation; that is to say, whether the Court has either jurisdiction to sanction it, or ought to sanction it. I do not think myself that the point of jurisdiction is worth discussing at much length, because everybody will agree that a compromise or agreement which has to be sanctioned by the Court must be reasonable, and that no arrangement or compromise can be said to be reasonable in which you can get nothing and give up everything. A reasonable compromise must be a compromise which can, by reasonable people conversant with the subject, be regarded as beneficial to those on both sides who are making it... The object of this section is not confiscation.'

In my judgment the submission of counsel for the objectors on this issue is correct... The word 'arrangement' in this section implies some element of give and take. Confiscation is not my idea of an arrangement. A member whose rights are expropriated without any compensating advantage is not, in my view, having his rights rearranged in any legitimate sense of that expression.

Note, however, that subsequent authority has affirmed the breadth of the term 'arrangement', with the 'give and take' requirement serving as the only definitional restriction on what amounts to an 'arrangement'. In *Re Savoy Hotel Ltd*<sup>420</sup> Nourse J (as he then was) made the following observation in this regard:

There can be no doubt that the word 'arrangement'... has for many years been treated as being one of very wide import... That is indeed a proposition for which any judge who has sat in this court in recent years would not require authority, and its validity is by no means diminished by what was said by Brightman J. in *In re N.F.U. Development Trust Ltd.* [1972] 1 W.L.R. 1548. All that that case shows is that there must be some element of give and take. Beyond that it is neither necessary nor desirable to attempt a definition of 'arrangement.'

With regard to the 'give and take' requirement note that although the 'give and take' may be between the company and the member it need not be; it may, for instance, be between the member and a third party who, through the scheme, is acquiring the shares or assets in the target company.<sup>421</sup>

<sup>420</sup> [1981] Ch 351.

<sup>421</sup> *Re T&N Ltd* [2006] EWHC 1447 (Ch) where David Richards J observes that 'as members' schemes such as that in *Re Savoy Hotel Ltd* show, the give and take need not be between the members and the company, but may be between the members and

## 2 Scheme process

The first stage in implementing a scheme of arrangement is an application to the court to obtain a court order providing for the holding of a meeting of the members or class of members affected by the scheme. No meeting is required of any class of member unaffected by the scheme.<sup>422</sup>

The application can be brought by the company, by a member, by a creditor or by a liquidator. A scheme can, therefore, in theory – although rarely in practice – be proposed and implemented without the support of the board of directors.

The following Court of Appeal extract explains the structure of the application process and the contemporary role of the court in the determination of which meetings of members or creditors need to be called in order to obtain the required approvals that are the prerequisites to the court exercising its discretion to sanction the scheme.

### ***Re MyTravel Group plc; Fidelity Investments International plc v MyTravel Group plc* [2005] 2 BCLC 123**

**Chadwick LJ**

[8] There are... three stages in the process by which a compromise or arrangement becomes binding as between the company and all its creditors (or all those creditors within the class of creditors with which the compromise or arrangement is made) and as between the company and all its members (or all those members within the relevant class). First, there must be an application to the court under [s 896]<sup>423</sup> of the Act for an order that a meeting or meetings be summoned. It is at that stage that a decision needs to be taken as to whether or not to summon more than one meeting; and, if so, who should be summoned to which meeting. Second, the scheme proposals are put to the meeting or meetings held in accordance with the order that has been made; and are approved (or not) by the requisite majority in number and value of those present and voting in person or by proxy. Third, if approved at the meeting or meetings, there must be a further application to the court under s [899] of the Act to obtain the court's sanction to the compromise or arrangement. This court adopted that analysis in *Re Hawk Insurance Co Ltd* [2001] 2 BCLC 480: see my judgment in that appeal with which the other members of the court agreed. In my judgment in *Re Hawk Insurance Co Ltd* I went on to say:

'It can be seen that each of those stages serves a distinct purpose. At the first stage the court directs how the meeting or meetings are to be summoned. It is concerned, at that stage, to ensure that those who are to be affected by the compromise or arrangement proposed have a proper opportunity of being present (in person or by proxy) at the meeting or meetings at which they are to be considered and voted upon. The second stage ensures that the proposals are acceptable to at least a majority in number, representing three-fourths in value, of those who take the opportunity of being present (in person or by proxy) at the meeting or meetings. At the third stage the court is

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a third party purchaser, with the company's only function being to register the transfer of shares and thereby terminate the existing members' status as members.'

<sup>422</sup> *Re British & Commonwealth Holdings Plc (No 3)* [1992] 1 WLR 672. Again note that we are not here concerned with the ways in which a scheme can be used to implement a compromise or arrangement between the company and its creditors.

<sup>423</sup> Original references to the sections of the Companies Act 1985 have been updated to refer to the corresponding sections of the Companies Act 2006.

concerned (i) to ensure that the meeting or meetings have been summoned and held in accordance with its previous order, (ii) to ensure that the proposals have been approved by the requisite majority of those present at the meeting or meetings, and (iii) to ensure that the views and interests of those who have not approved the proposals at the meeting or meetings (either because they were not present or, being present, did not vote in favour of the proposals) receive impartial consideration.’

[9] In my judgment in *Re Hawk Insurance Co Ltd* I addressed the need to identify correctly, at the first stage, those between whom and the company it is proposed that a compromise or arrangement is to be made. As I put it:

‘Are the rights of those who are to be affected by the scheme proposed such that the scheme can be seen as a single arrangement; or ought the scheme to be regarded, on a true analysis, as a number of linked arrangements? The question may be easy to state; but, as the cases show, it is not always easy to answer.’

I pointed out that, if that question were not addressed and answered correctly at the first stage, the court would find, at the third stage, that the condition precedent to the exercise of its power to sanction the arrangement was absent. None of the linked arrangements would have been approved by the requisite majority at a relevant meeting because there would not have been meetings of the distinct classes.

[10] It is for the applicant to identify, when making the application, with whom it is proposed that the compromise or arrangement is to be made; and to identify the class or classes of creditors (or members, as the case may be) who are to be summoned to a meeting or meetings convened under s [896] of the Act. But, as I pointed out in *Re Hawk Insurance Co Ltd* of my judgment, it might be thought that the structure of the statutory provisions required the court to consider, at the first stage when deciding whether or not to order a meeting or meetings to be summoned, whether the class or classes which the applicant had chosen were (on a true analysis) properly constituted. As I have said, the danger was that a scheme which, at first sight, appeared to involve a single compromise or arrangement with all the creditors with whom it was to be made (or all the members, as the case might be) might be seen (on closer analysis) to be two or more linked compromises or arrangements with creditors (or members) whose rights put them in several and distinct classes.

[11] The effect of the practice followed in the Companies Court at the time of the application in *Re Hawk Insurance Co Ltd* (set out in *Practice Note* [1934] WN 142 issued by Eve J some 65 years earlier) was that the court gave no consideration to that question at the first stage. The fact that the court had made an order under s [896] of the... Act for a meeting or meetings to be held could not be taken to imply that the court had addressed its mind at all to the question whether those were the meetings which the scheme proposed actually required before sanction can be given under [s 899] of the Act. The question whether or not those were the meetings which the scheme actually required was left to be decided at the third stage; by which time a wrong decision by the applicant at the outset would have led to a considerable waste of time and expense.

[12] I suggested in my judgment in *Re Hawk Insurance Co Ltd* that the practice then followed in the Companies Court merited re-examination. That suggestion bore fruit. On 15 April 2002 the Vice-Chancellor issued a statement of the practice to be followed in future: see *Practice Statement (companies: schemes of arrangement)* [2002] 3 All ER 96, [2002] 1 WLR 1345. The purpose of the revised practice was ‘to enable issues concerning the composition of classes of creditor and the summoning of meetings to be identified and if appropriate resolved early in the proceedings’. Paragraphs 4 and 5 of the practice statement were in these terms:



‘4. It is the responsibility of the applicant by evidence in support of the application or otherwise to draw to the attention of the court as soon as possible any issues which may arise as to the constitution of meetings of creditors or which otherwise affect the conduct of those meetings (creditor issues). For this purpose unless there are good reasons for not doing so the applicant should take all steps reasonably open to it to notify any person affected by the scheme that it is being promoted, the purpose which the scheme is designed to achieve, the meetings of creditors which the applicant considers will be required and their composition.

5. In considering whether or not to order meetings of creditors (a meetings order) the court will consider whether more than one meeting of creditors is required and if so what is the appropriate composition of those meetings.’

As we see from the above extract, it is in the first instance the applicant’s responsibility to determine the classes of meetings that are required to be held. The court, however, will no longer simply defer to this determination because, as Chadwick LJ observes, if there is a problem in this regard then the court is unable subsequently to sanction the scheme and effectively the scheme process has to start again. The court’s new-found willingness to play a proactive role in determining whether the class meetings have been properly constituted will reduce the probability that a scheme will not be sanctioned because of a failure to obtain the correct approvals. Note that while the courts are now willing to play a proactive role in relation to member class meetings, the practice statement that was set in motion by Chadwick LJ’s judgment in *Re Hawk Insurance Co Ltd*<sup>424</sup> relates directly to the composition of creditor class meetings. This reflects the often greater complexity involved in determining whether the various creditors of the company are appropriately grouped into different classes of creditor. These creditor class considerations are beyond the scope of this chapter’s control transaction focus.

In most instances the composition of member meetings will be relatively easy to determine. Most companies will set out the different classes of shares in their constitutions. There are, of course, harder borderline cases that the fact patterns in *Cumbrian Newspapers Group Ltd v Cumberland & Westmorland Herald Newspaper & Printing Co Ltd*<sup>425</sup> and the *Eurotunnel* case demonstrate. The class determination case-law typically relates to the determination of creditor rather than member classes. However, the direction on class determination given in these cases is applicable where member class determination is more difficult. The leading case in this regard is *Sovereign Life Assurance Co v Dodd*:<sup>426</sup>

The Act provides that ‘the creditors or any class of creditors’ may be called to a meeting, and that the agreement of the majority shall bind the minority; it exercises a very formidable compulsion upon dissentient, or would-be dissentient, creditors; it must consequently be construed carefully so as not to enable some creditors to compel others to do that which it would be unreasonable to require them to do, or to play with the interests of the minority.... The word ‘class’ used in the statute is vague, and to find out what it means we must look at the general scope of the section, which enables the court to order a meeting of a ‘class of creditors’ to be summoned. It seems to me that we must give such a meaning to the term ‘class’ as will prevent the section being so worked as to produce confiscation and injustice, and that we must confine its meaning

<sup>424</sup> [2001] 2 BCLC 480.

<sup>425</sup> [1986] BCLC 286.

<sup>426</sup> [1891–94] All ER Rep 246.

to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.<sup>427</sup>

### 3 Scheme meetings

Pursuant to section 896 of the Companies Act 2006, following the scheme application, the court will order the holding of the meeting. The Act does not provide a time-frame for the holding of the meeting. Typically courts have provided for a 21-day notice period. However, following the reduction of a typical notice period for a general meeting to 14 days<sup>428</sup> there is a 'market' expectation that the courts will provide for a 14-day notice period for scheme meetings.<sup>429</sup> When shareholders are given notice of the scheme meeting, section 897 of the Act provides that they must also be provided with a statement (the 'scheme document') about the scheme which explains to shareholders: (1) the effects of the compromise or arrangement; and (2) the material interests of the directors and the effects the compromise or arrangement has on those interests. Note that where the scheme is subject to the requirements of the Takeover Code (discussed further in III below) the scheme document must comply with the information requirements of the Code.

Pursuant to section 899 of the Act, a precondition to the court exercising its discretion to sanction the scheme is that the scheme has been approved in the meeting by a majority of votes cast in each meeting and where that majority represents 75% *by value* of the class of shareholders voting at the meeting.

### 4 Court sanction of the scheme

Pursuant to section 899 of the Companies Act 2006, following the members meeting(s) in which the required approvals are obtained, a second application must then be made to the court to request the court's sanction of the scheme. Section 899 provides the court with a discretion as to whether or not to approve the scheme. However, the Act does not provide any guidelines or criteria of relevance for exercising this discretion. With regard to the court's general approach to exercising its discretion consider the following case extracts. Note that while several cases referred to below relate to a creditors' scheme, the approach taken by the courts applies to both members' and creditors' schemes.

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<sup>427</sup> While this remains the leading case, courts have shown great awareness of the danger of rendering schemes unworkable if there is excessive class subdivision. See *Re Anglo American Insurance Ltd* [2001] 1 BCLC 755 where Neuberger J observed that 'if one gets too picky about potential different classes, one could end up with virtually as many classes as there are members of a particular group.' See also *Re Hawk Insurance Co Ltd* [2001] 2 BCLC 480 in this regard.

<sup>428</sup> For public company AGMs the notice period is 21 days; for other public company meetings and all private company meetings the notice period will typically be 14 days (section 307 and 307A CA 2006). Note that the Companies Act 2006 has been amended to implement the EU's Shareholder Rights Directive (2007/36/EC) which means that for 'traded companies' (which are companies limited by shares and traded on an EEA regulated market, section 360C CA 2006) there are certain preconditions to being able to use the 14 day period, for example, the ability to vote electronically, and in the absence of compliance with such conditions the notice period is 21 days (section 307A). The Shareholder Rights Directive has been implemented in the UK by The Companies (Shareholders' Rights) Regulations 2009 No. 1632.

<sup>429</sup> See Practical Law Company: *Schemes of Arrangement: Overview* (Reference: [www.practicallaw.com/2-107-4433](http://www.practicallaw.com/2-107-4433)). Section 307 CA 2006.

***Re Dorman, Long and Co Ltd* [00400 of 1933] [1934] Ch 635**

**Maugham J**

I will first state my view as to the function of the Court in determining whether the compromise or arrangement should be sanctioned by the Court. It is plain that the duties of the Court are two-fold. The first is to see that the resolutions are passed by the statutory majority in value and number, in accordance with [section 899 of the Act]<sup>430</sup> at a meeting or meetings duly convened and held. Upon that depends the jurisdiction of the Court to confirm the scheme. The other duty is in the nature of a discretionary power, and it has been the subject of two decisions in the Court of Appeal, the first being the case of *In re Alabama, New Orleans, Texas and Pacific Junction Ry. Co.*<sup>431</sup> and the second the case of *In re English, Scottish, and Australian Chartered Bank.*<sup>432</sup> In the first of these cases, it is true, Lindley L.J. observed: 'the Court must look at the scheme, and see... whether the scheme is a reasonable one or whether there is any reasonable objection to it, or such an objection to it as that any reasonable man might say that he could not approve of it.' I think that those phrases, which were contained in a judgment which had not been reserved, do not represent exactly what the Lord Justice intended. I prefer, as representing the view of the Court of Appeal, the language in the statement of Bowen L.J. that 'a reasonable compromise must be a compromise which can, by reasonable people conversant with the subject, be regarded as beneficial to those on both sides who are making it,' and he added, to explain that, '.... I have no doubt at all that it would be improper for the Court to allow an arrangement to be forced on any class of creditors, if the arrangement cannot reasonably be supposed by sensible business people to be for the benefit of that class as such...' Fry L.J. said: '... the Court... must be satisfied that the proposal was at least so far fair and reasonable, as that an intelligent and honest man, who is a member of that class, and acting alone in respect of his interest as such a member, might approve of it'... In my opinion, then, so far as this second duty is concerned, what I have to see is whether the proposal is such that an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve.

***Re BTR plc* [2000] 1 BCLC 740**

**Chadwick LJ**

The court is not bound by the decision of the meeting. A favourable resolution at the meeting represents a threshold which must be surmounted before the sanction of the court can be sought. But if the court is satisfied that the meeting is unrepresentative, or that those voting in favour at the meeting have done so with a special interest to promote which differs from the interest of the ordinary independent and objective shareholder, then the vote in favour of the resolution is not to be given effect by the sanction of the court.

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<sup>430</sup> Section numbers have been updated to reflect the current 2006 Act.

<sup>431</sup> [1891] 1 Ch 213.

<sup>432</sup> [1893] 3 Ch 385.

***Re Telewest Communications plc (No 2); Re Telewest Finance (Jersey) Ltd (No 2)* [2005] 1 BCLC 772**

**David Richards J**

The classic formulation of the principles which guide the court in considering whether to sanction a scheme was set out by Plowman J in *Re National Bank Ltd*<sup>433</sup> [1966] 1 All ER 1006 by reference to a passage in *Buckley on the Companies Acts* (13th edn, 1957) p 409, which has been approved and applied by the courts on many subsequent occasions:

‘In exercising its power of sanction the court will see, first, that the provisions of the statute have been complied with; secondly, that the class was fairly represented by those who attended the meeting and that the statutory majority are acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent, and thirdly, that the arrangement is such as an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve.

The court does not sit merely to see that the majority are acting bona fide and thereupon to register the decision of the meeting; but at the same time the court will be slow to differ from the meeting, unless either the class has not been properly consulted, or the meeting has not considered the matter with a view to the interests of the class which it is empowered to bind, or some blot is found in the scheme.’

This formulation in particular recognises and balances two important factors. First, in deciding to sanction a scheme under [section 899], which has the effect of binding members or creditors who have voted against the scheme or abstained as well as those who voted in its favour, the court must be satisfied that it is a fair scheme. It must be a scheme that ‘an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve’. That test also makes clear that the scheme proposed need not be the only fair scheme or even, in the court’s view, the best scheme. Necessarily there may be reasonable differences of view on these issues.

The second factor recognised by the above-cited passage is that in commercial matters members or creditors are much better judges of their own interests than the courts. Subject to the qualifications set out in the second paragraph, the court ‘will be slow to differ from the meeting’.

There are two aspects of the court’s role in exercising its discretion to sanction the scheme. The first is ensuring that the required approvals were obtained in the duly convened meetings. The second involves the application of an objective standard to ensure that the scheme is carried out in the members’ interests.

With regard to the meeting approvals, at this stage of the process those who object to the scheme may raise objections about the adequacy of the information provided to members in the notice of the meeting as well as in the scheme document provided in accordance with section 897. In this regard, case-law on the provision of information to shareholders asked to approve any shareholder resolution has been applied to the scheme approvals.<sup>434</sup> In *RAC Motoring Services Ltd* Neuberger J, in considering the adequacy of the information about the

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<sup>433</sup> Note that *Re National Bank Ltd* involved a member’s scheme.

<sup>434</sup> See *Kaye v Croydon Tramways Co* [1898] 1 Ch 358; *Tiessen v Henderson* [1899] 1 Ch 861.

scheme, referred with approval to the Australian case of *Residues Treatment & Trading Co Ltd v Southern Resources Ltd*.<sup>435</sup>

It is unnecessary for the directors to give to shareholders in a notice convening a meeting of this kind every piece of information which might conceivably affect their voting... It is sufficient if directors make a full and fair disclosure of all matters within the knowledge of the directors which would enable shareholders to make a properly informed judgment on the matters intended to be submitted to them.

Having ascertained that the requisite approvals were duly obtained, the court charged with sanctioning of the scheme will then assess the fairness of the scheme. As noted in the extract from the *Re MyTravel Group plc*<sup>436</sup> judgment above, in determining whether the scheme is fair, the court will ensure 'that the views and interests of those who have not approved the proposals at the meeting or meetings (either because they were not present or, being present, did not vote in favour of the proposals) receive impartial consideration'.

The primary standard that is applied by the courts to determine whether the scheme is fair and should be sanctioned is the test articulated by Fry LJ in *Re Alabama, New Orleans, Texas and Pacific Junction Ry Co*: whether an intelligent and honest man, who is a member of the class, acting alone in his interests would approve of the scheme. The court asks whether the scheme can be objectively construed as being in the interests of such a member. Importantly, as observed by David Richards J in *Re Telewest Communications*, the court is not asking whether the scheme represents the best possible arrangement for the shareholders; it need only be a 'fair' scheme, which means it can be construed as being in the members' interests. The court in *Re Telewest*, citing Plowman J's judgment in *Re National Bank*, also observes that in exercising its discretion to approve the scheme, the court must ensure that the majority has not coerced the minority to promote interests adverse to those of the class. In this regard, Chadwick LJ in *Re BTR* observes that the court will not sanction the meeting where the vote furthers special interests contrary to the interests of the members as a whole. It is submitted, however, that these 'additional tests' are subsumed within the 'intelligent and honest member acting alone in his interest' test outlined above: if the scheme can be construed as being in the interests of such a hypothetical member then it does not coerce that member and will be sanctioned, even if the majority were in fact motivated by other interests.

Importantly, while this standard does require the court's objective assessment of whether it can be understood to benefit the applicable members, the courts adopt a deferential stance vis-à-vis the meeting's decision. Aware that members themselves are better placed to assess the merits of the scheme, the courts will be 'slow to differ from the meeting' when applying this standard. Accordingly, provided that the scheme benefits from an explanation of why it benefits members and there is no indication that the meeting process was flawed, then the court is unlikely to disturb the meeting's decision.

## 5 The effect of court sanction

After the sanction of the court has been obtained for the scheme, the court order must be delivered to the Companies Registrar.<sup>437</sup> Following such delivery the scheme comes into effect and, importantly, is binding on all members of the scheme that were asked to vote on the scheme. That is, it is binding on objecting members as well.

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<sup>435</sup> (1988) 14 ACLR 375

<sup>436</sup> [2005] 2 BCLC 123.

<sup>437</sup> Section 899(4) CA 2006.

## II Mergers

### 1 *Reconstructions and amalgamations*

As we observed in A.II of this chapter, most common and civil law jurisdictions provide for a statutory merger mechanism enabling two companies to merge together or to merge into a third company. Typically this will require the approval of both companies' boards of directors and both companies' shareholders. Consider, for example, Delaware's merger mechanism set out in section 251 of the Delaware General Corporation law.

#### **Delaware General Corporation Law**

##### **Section 251. Merger or consolidation of domestic corporations**

(a) Any 2 or more corporations existing under the laws of this State may merge into a single corporation, which may be any 1 of the constituent corporations or may consolidate into a new corporation formed by the consolidation, pursuant to an agreement of merger or consolidation, as the case may be, complying and approved in accordance with this section.

(b) The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation and declaring its advisability...

(c) The agreement required by subsection (b) of this section shall be submitted to the stockholders of each constituent corporation at an annual or special meeting for the purpose of acting on the agreement. Due notice of the time, place and purpose of the meeting shall be mailed to each holder of stock... The notice shall contain a copy of the agreement or a brief summary thereof, as the directors shall deem advisable. At the meeting, the agreement shall be considered and a vote taken for its adoption or rejection. If a majority of the outstanding stock of the corporation entitled to vote thereon shall be voted for the adoption of the agreement, that fact shall be certified on the agreement by the secretary or assistant secretary of the corporation, provided that such certification on the agreement shall not be required if a certificate of merger or consolidation is filed in lieu of filing the agreement. If the agreement shall be so adopted and certified by each constituent corporation, it shall then be filed and shall become effective...

The Companies Act 2006 does not provide for a statutory merger mechanism enabling the merger of two companies following merely board and shareholder approvals of both companies. However, the Act provides for a similar mechanism through the scheme of arrangement, although it is rarely used in UK corporate practice.<sup>438</sup> As discussed above, the term 'arrangement' has been interpreted very loosely and clearly would encompass a merger between two or more companies. The Act directly confirms this by providing the courts with specific powers to effect a scheme of arrangement that provides for a 'reconstruction' or 'amalgamation'. These powers are set out in section 900 of the Act.

#### **Section 900 CA 2006 Powers of court to facilitate reconstruction or amalgamation**

(1) This section applies where application is made to the court under section 899 to sanction a compromise or arrangement and it is shown that—

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<sup>438</sup> P. Davies, *Gower and Davies' Principles of Modern Company Law* (8th edn), p 1071 describing the scheme based merger as a dead letter.

- (a) the compromise or arrangement is proposed for the purposes of, or in connection with, a scheme for the reconstruction of any company or companies, or the amalgamation of any two or more companies, and
  - (b) under the scheme the whole or any part of the undertaking or the property of any company concerned in the scheme ('a transferor company') is to be transferred to another company ('the transferee company').
- (2) The court may, either by the order sanctioning the compromise or arrangement or by a subsequent order, make provision for all or any of the following matters—
- (a) the transfer to the transferee company of the whole or any part of the undertaking and of the property or liabilities of any transferor company;
  - (b) the allotting or appropriation by the transferee company of any shares, debentures, policies or other like interests in that company which under the compromise or arrangement are to be allotted or appropriated by that company to or for any person;
  - (c) the continuation by or against the transferee company of any legal proceedings pending by or against any transferor company;
  - (d) the dissolution, without winding up, of any transferor company;
  - (e) the provision to be made for any persons who, within such time and in such manner as the court directs, dissent from the compromise or arrangement;
  - (f) such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation is fully and effectively carried out.
- (3) If an order under this section provides for the transfer of property or liabilities—
- (a) the property is by virtue of the order transferred to, and vests in, the transferee company, and
  - (b) the liabilities are, by virtue of the order, transferred to and become liabilities of that company...
- (5) In this section—  
 'property' includes property, rights and powers of every description; and  
 'liabilities' includes duties.

Section 900(1) makes the powers set out in subsection (2) available to the court where the scheme involves either a 'reconstruction' or an amalgamation, and which involve a transfer of 'the whole or any part of the undertaking or the property of any company concerned in the scheme' to another company. On the meaning of 'reconstruction' and 'amalgamation' consider Buckley J's observations on the meanings of these terms<sup>439</sup> in *In re South African Supply and Cold Storage Company*.<sup>440</sup>

Neither of these words, 'reconstruction' and 'amalgamation', has any definite *legal* meaning. Each is a commercial and not a legal term, and, even as a commercial term, bears no exact definite meaning. In each case one has to decide whether the transaction is such as that, in the meaning of commercial men, it is one which is comprehended in the term 'reconstruction' or 'amalgamation'...

<sup>439</sup> Note that Buckley J was not interpreting the provisions of the Acts; he was interpreting these terms in the subject company's articles of association. Lawrence Collins J in *IAF Securities Ltd v Loyalward Ltd* (All England Official Transcripts (1997–2008)) appeared to view as useful in understanding the provisions of the Act.

<sup>440</sup> [1904] 2 Ch 268.

What does 'reconstruction' mean? To my mind it means this. An undertaking of some definite kind is being carried on, and the conclusion is arrived at that it is not desirable to kill that undertaking, but that it is desirable to preserve it in some form, and to do so, not by selling it to an outsider who shall carry it on – that would be a mere sale – but in some altered form to continue the undertaking in such a manner as that the persons now carrying it on will substantially continue to carry it on. It involves, I think, that substantially the same business shall be carried on and substantially the same persons shall carry it on. But it does not involve that all the assets shall pass to the new company or resuscitated company, or that all the shareholders of the old company shall be shareholders in the new company or resuscitated company. Substantially the business and the persons interested must be the same. Does it make any difference that the new company or resuscitated company does or does not take over the liabilities? I think not. I think it is none the less a reconstruction because from the assets taken over some part is excepted provided that substantially the business is taken, and it is immaterial whether the liabilities are taken over by the new or resuscitated company or are provided for by excepting from the scheme of reconstruction a sufficient amount to answer them. It is not, therefore, vital that either the whole assets should be taken over or that the liabilities should be taken over. You have to see whether substantially the same persons carry on the same business; and if they do, that, I conceive, is a reconstruction.

Now what is an amalgamation? An amalgamation involves, I think, a different idea. There you must have the rolling, somehow or other, of two concerns into one. You must weld two things together and arrive at an amalgam – a blending of two undertakings. It does not necessarily follow that the whole of the two undertakings should pass – substantially they must pass – nor need all the incorporators be parties, although substantially all must be parties. The difference between reconstruction and amalgamation is that in the latter is involved the blending of two concerns one with the other, but not merely the continuance of one concern. An amalgamation may take place, it seems to me, either by the transfer of undertakings A and B to a new corporation, C., or by the continuance of A and B by B upon terms that the shareholders of A shall become shareholders in B. It is not necessary that you should have a new company. You may have a continuance of one of the two companies upon the terms that the undertakings of both corporations shall substantially be merged in one corporation only.

Confirming this view of a reconstruction consider *Pennycuik J in Brooklands Selangor Holdings Ltd v IRC*<sup>441</sup> who explained the term as follows:

In ordinary speech the word reconstruction is, I think, used to describe the refashioning of any object in such a way as to leave the basic character of the object unchanged. In relation to companies, the word 'reconstruction' has a fairly precise meaning which corresponds, so far as the subject matter allows, to its meaning in ordinary speech. It denotes the transfer of the undertaking or part of the undertaking of an existing company to a new company with substantially the same persons as were members of the old company.<sup>442</sup>

<sup>441</sup> [1970] 2 All ER 76.

<sup>442</sup> See also *Re MyTravel Group plc; Fidelity Investments International plc v MyTravel Group plc* [2005] 2 BCLC 123 per Mann J holding that 'the company is reconstructed when those incorporators, who for these purposes are treated as carrying on the business of the company, are the same in both the old and the new companies.'



The court can implement a scheme involving a reconstruction or amalgamation by, pursuant to powers provided by section 900(2), providing for, amongst others: the transfer of the relevant undertaking, property or liabilities of the transferor company; law suits of the transferor company; and any allotment of shares by the transferee company.<sup>443</sup> Pursuant to subsection (3) the property and the liabilities are transferred by virtue of the order; by operation of law. Property is defined very broadly under subsection (5) to include contractual rights from which the company benefits. However, with regard to contractual rights, the ability of the court to provide for the transfer of contracts is limited to the contracts that are capable of assignment. In this regard, the House of Lords in *Nokes v Doncaster Amalgamated Collieries Ltd*<sup>444</sup> considered whether a contract of employment could be transferred from one company to another by virtue of the powers granted to the court by section 154 of the Companies Act 1929, an identical predecessor provision to section 900(2)(a) of the Companies Act 2006. The court held that in the absence of the employee's consent the contract was not transferable and that the power provided by the Act was not capable of providing for the transfer of contractual rights where the contracting counterparty had reserved the right to consent to or veto any such transfer. Drawing on *Duke of Portland v Baird & Co*<sup>445</sup> and the example of the lease of mining rights Lord Thankerton observed that:

'Can anything be more natural – or, I should say, more expedient – for the landlord, than that he should hold in his hand the power, not of rejecting this or that assignee or subtenant, but of determining absolutely, and with a view to his own wishes and interests only, whether at any particular time there shall be an assignation or sublease at all?'<sup>446</sup> In the absence of explicit provision to that effect, I am unable to find in the terms of section 154 anything to deprive the mineral landlord of such a right.

## 2 Public company mergers

Part 27 of the Companies Act 2006 adapts the scheme arrangement mechanism to certain 'mergers' and transfers of 'divisions' between and from public companies. This Part of the Act implements the Third and Sixth Company Law Directives<sup>447</sup> and results in the imposition of additional requirements to such schemes of arrangement. If a scheme does not fall within the Part 27 'catchment area' the arrangement is subject only to the requirements of Part 26 of the Act discussed above. It is noteworthy that in many instances, it will be relatively straightforward to avoid the application of Part 27 simply by altering the form of consideration or by using an existing private subsidiary company rather than the public parent company as

<sup>443</sup> Section 901 empowers the order sanctioning the scheme to alter the applicable company's articles.

<sup>444</sup> [1940] AC 1014.

<sup>445</sup> (1865) 4 Macp 10. Lord Atkin in *Nokes v Doncaster Amalgamated Collieries Ltd* observes that 'I am satisfied that this in the main procedural section should not be construed so as to transfer rights which in their nature are by law not transferable.'

<sup>446</sup> Per Clerk Inglis LJ in *Duke of Portland v Baird & Co* (1865) 4 Macp 10.

<sup>447</sup> Third Council Directive concerning mergers of public limited companies (78/855/EEC) and Sixth Council Directive concerning the division of public limited liability companies (82/891/EEC).

one of the merging companies. In this regard, in 2005 Jonathan Rickford observed that to his knowledge these provisions had never been used in practice.<sup>448</sup>

Part 27 applies to 'mergers' and 'divisions'. A merger is defined in section 904 of the Act as either a *merger by absorption* whereby the 'undertaking, property and liabilities' of a *public* company is transferred to another *public* company or a *merger by formation of a new company* whereby the 'undertaking, property and liabilities' of two or more public companies are transferred into a newly formed company, *whether public or private*. Pursuant to section 919, a division involves the transfer by a company, *whether public or private*, or its 'undertaking, property and liabilities' to two or more *public companies* or newly formed companies, *whether public or private*. Importantly, the requirements of Part 27 only apply to mergers and divisions as defined above where all or part of the consideration for the transfer is shares in the transferee company. It does not, therefore, apply to cash-out mergers and divisions where the shareholders in the transferee company receive cash only.<sup>449</sup>

The effect of a scheme of arrangement falling within the Part 27 'catchment area' is that the scheme of arrangement is subject to certain additional requirements in addition to the shareholder approval and court-sanction requirements outlined in C.I above. We shall address these additional requirements only in outline here. The key additional requirements are as follows:

- A draft terms of the scheme must be prepared and adopted by the boards of directors of all the merging companies.<sup>450</sup> The directors of each of the merging companies or the companies involved in the division must deliver a copy of the terms to Companies House.<sup>451</sup>
- The directors must prepare an explanatory report of the scheme which, in addition to the scheme statement prepared in accordance with section 897 required for any scheme, must address the 'legal and economic grounds for the draft terms', in particular in relation to the share exchange ratio, and identify any 'special valuation difficulties'.<sup>452</sup> This applies also to divisions. However, in relation to divisions the Act requires, in addition, information on the criteria that determined the allocation of shares in the transferee company to the shareholders in the transferor company.<sup>453</sup>
- In relation to mergers and divisions subject to Part 27, the Act requires the preparation of an expert's report by each of the applicable companies.<sup>454</sup> The companies may

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<sup>448</sup> J. Rickford, 'The Proposed Tenth Company Law Directive on Cross Border Mergers and its Impact in the UK' (2005) European Business Law Review 1395, 1398.

<sup>449</sup> Section 902(1)(c) CA 2006. Note also that Part 27 of the Act does not apply if the company which is transferring its undertaking, property and liabilities is being wound up. The additional requirements set out below could therefore be avoided by putting the company into liquidation before commencing the merger process.

<sup>450</sup> Section 905 CA 2006 for mergers; section 920 CA 2006 for divisions.

<sup>451</sup> Sections 906 and 921 CA 2006 for mergers and divisions respectively.

<sup>452</sup> Section 908 CA 2006.

<sup>453</sup> Section 923 CA 2006.

<sup>454</sup> Sections 909 and 924 CA 2006 for mergers and divisions respectively.

obtain court approval for a joint report.<sup>455</sup> The expert, who must be an independent<sup>456</sup> statutory auditor,<sup>457</sup> is required to prepare a report on the share consideration to be issued in the merger or division. This includes giving an opinion on whether the methods used in reaching the share exchange ratio are reasonable; whether the share exchange is itself reasonable; and whether any 'special valuation difficulties' have arisen.<sup>458</sup>

- In relation to a merger by absorption, where the merger is between a parent and wholly owned subsidiary, the requirements to prepare a director's explanatory report and to obtain an expert's report do not apply.<sup>459</sup>
- If any of the relevant companies' annual accounts were prepared as of a date more than seven months prior to the shareholder meeting called to approve the scheme, a supplementary balance sheet must be prepared as of a date no more than three months prior to the directors' adoption of the draft terms of the merger.<sup>460</sup>
- The meeting requirements to approve the merger or division schemes are the same as in any scheme: majority of the votes cast representing 75% by value of the class voting.<sup>461</sup> However, in relation to a merger by absorption, where all the shares of the transferor company are owned by the transferee company no meeting of transferee or transferor company is required.<sup>462</sup> However, a meeting of the transferee company's shareholders will have to be called where shareholders holding 5% of the shares require one to be held to approve the scheme.<sup>463</sup>
- No meeting of the transferee company is required where the transferee company owns 90% of the voting shares of the transferor company, provided that no meeting has been requested by shareholders holding 5% of the transferee voting shares.<sup>464</sup> In such

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<sup>455</sup> Sections 909(3) and 924(3) CA 2006 for mergers and divisions respectively.

<sup>456</sup> Section 936 CA 2006 sets forth provisions that the expert statutory auditor must comply with in order to be an independent expert. These independence requirements are effectively the same as the statutory auditor independence requirements set forth in section 1214 CA 2006 discussed in detail in Web Chapter B.

<sup>457</sup> Sections 909(4) and 924(4) CA 2006 for mergers and divisions respectively.

<sup>458</sup> Sections 909(5) and 924(5) CA 2006 for mergers and divisions respectively.

<sup>459</sup> Section 915 CA 2006.

<sup>460</sup> Section 910 and 925 CA 2006 for mergers and divisions respectively.

<sup>461</sup> Sections 907 and 922 CA 2006 for mergers and divisions respectively.

<sup>462</sup> Section 917. This is subject to the publication and inspection conditions set out in section 917(3) and (4) CA 2006.

<sup>463</sup> Section 917(5) CA 2006.

<sup>464</sup> Section 916 CA 2006.

circumstances a meeting of the transferor company is still required. Somewhat oddly, section 918 of the Act provides that no meeting is required of the transferee company, without the 90% threshold requirement, provided that no 5% shareholder or group of shareholders have requested a meeting.

- Sections 931 and 932 of the Act provide for similar exceptions for divisions from the requirement to hold a shareholder meeting to approve the scheme.

### III Schemes and the Takeover Code

The Takeover Code regulates takeover bids and merger transactions of the companies that fall within the ambit of its jurisdiction. The Code primarily uses the term 'offer' in setting forth its regulation of these transactions. The term 'offer' as it is commonly used fits clearly into the box of contractual offer and acceptance: an offer from one party – the bidder – to purchase the shares of another party – the shareholder, which the shareholder decides whether or not to accept. This is how we have used the term 'takeover offer' in this chapter. However, the term 'offer' is defined in the Code more broadly than this to include 'any transaction subject to the Code'. In section 3(b) of the introduction to the Code the Code clarifies that this includes both such contractual offers but also control transactions implemented by a scheme of arrangement.<sup>465</sup>

Accordingly, the core provisions of the Code regulating the nature of the bid,<sup>466</sup> the consideration to be paid,<sup>467</sup> the information to be provided to shareholders (in the case of scheme in the scheme document or circular)<sup>468</sup> and the conditions attached to the bid all apply to schemes of arrangement.<sup>469</sup> Some aspects of the Code, however, cannot be consistently or sensibly applied to a scheme and the Code provides for a list of these in paragraph 14 of Appendix 7 of the Code. Most importantly in this regard, the timing provisions in Rule 31 do not apply as the court controls the scheme process; the acceptance condition in Rule 10 does not make sense as in a scheme all shareholders are bound by the scheme if the requisite shareholder approvals and court sanction are obtained; withdrawal rights provided by Rule 34 do not make sense where the transaction does not involve a contractual offer.

Finally, it should be noted that while traditionally contractual takeover offers have been the preferred means of effecting a takeover bid, in the past few years cancellation and reduction schemes have become a very popular method of implementing takeover bids.<sup>470</sup> There are

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<sup>465</sup> Takeover Code Introduction, section 3(b): 'the Code is concerned with regulating takeover bids and merger transactions of the relevant companies, however effected, including by means of statutory merger or scheme of arrangement.'

<sup>466</sup> See web Chapter A, B.II above.

<sup>467</sup> *Ibid.*

<sup>468</sup> *Ibid.*

<sup>469</sup> *Ibid.*

<sup>470</sup> 'Of the 55 UK public M&A deals with a value of £250 million and above announced between January 2007 and 25 August 2008, forty were announced or subsequently restructured as schemes of arrangement' – O'Donnell, Sweeney, Eversheds, 'Takeovers by way of Scheme of Arrangement: A future trend' (2008).

two reasons for this. The first reason is that it enables the bidder to ensure that she obtains 100% control of the company where a simple majority in number representing 75% in value of the voting shareholder support the transaction. In a contractual offer the bidder can only get 100% control if she obtains sufficient acceptances to be able to use the squeeze-out mechanism provided by the Companies Act 2006.<sup>471</sup> The second reason for the scheme's popularity is that a transfer of shares in a contractual offer attracts stamp duty whereas a cancellation of existing shares and an issue of new shares to the bidder does not.<sup>472</sup>

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<sup>471</sup> *Ibid.*

<sup>472</sup> Finance Act 1999, Schedule 13, paras 1–3 and section 112(3) Finance Act 1999 giving effect to the Schedule 13.