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Backing the Target Board: Proposed Changes to Rebalance UK Takeover

Last year, Kraft's bid for Cadbury generated widespread debate among market participants, politicians and the general public about whether it was too easy for hostile bidders to take over UK companies. That debate has resulted in the Code Committee of the Takeover Panel (the Panel) publishing a public consultation paper (the PCP) setting out proposed changes to the UK Takeover Code (the Code).

The proposed changes, which are designed to redress the perceived tactical imbalance favouring bidders under the current rules, are subject to further consultation and amendment and expected to be implemented in the third or early fourth quarter of this year. Final rules will be published approximately one month prior to the changes becoming effective. The Panel does not believe that a lengthy transition or implementation period will be necessary.

As some of the proposed changes would have a significant impact on the initial bid phase, potential bidders for UK companies need to factor them into their current thinking to ensure that their strategic options are not compromised when the changes take effect.

This article focuses on two of the key changes currently proposed, which we believe are most important from a commercial and strategic perspective: the reduction of the so-called "virtual bid" period and the banning of deal protection mechanisms.

Reducing Virtual Bids — The 28-Day Shot Clock

One of the purposes of the Code is to prevent the creation of a false market. The keystone of the Code structure in this regard is the obligation of parties to maintain secrecy in the early phases of bid consideration and release a public announcement where the Panel determines there has been a leak, as is typically evidenced by an untoward movement in the target stock price, or rumour and speculation.

Historically, it has been possible for the target to release an announcement that it has received an approach from an unnamed bidder. That announcement would start an offer period, which exposes the target to, in the Panel's words, a "period of uncertainty and disruption." The target has been able to end this period by naming the bidder (if not already identified publicly) and then requesting that the Panel set a deadline by which the bidder must either: (i) make a (fully financed) firm offer; or (ii) announce that it has no intention to bid, which, except in limited circumstances, would preclude it from making an offer for six months.

Under the new rules, an announcement of a possible offer released by a target would have to identify all bidders who had approached the target, and those bidders would be required either to make a bid or walk away within 28 days. The Panel believes the 28-day deadline will encourage secrecy and limit the period of uncertainty and disruption faced by targets (since target boards will not have to make the "difficult and contentious" decision to request a deadline for a bid). However, the forced outing of all potential bidders, some of whom may be more advanced, creates the risk that a more prepared bidder will leak its intentions in order to flush out other bidders and gain an advantage over those who are unable to meet the 28-day deadline.

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The Panel has said it normally will grant an extension to the 28-day deadline if it is requested by the target, and the target board will be able to request an extension for one bidder but not others. It is unclear in what circumstances (if any) the Panel would refuse to grant an extension requested by a target board.

There are two significant exceptions to the operation of the proposed 28-day deadline. First, where an offer period is started by the target announcing that it is for sale, bidders participating in that process will not be subject to the deadline *for so long as they participate in that process*. Second, recognising the stresses the new rules will put on publicity-shy bidders, the Panel proposes to formalise what has until now been an informal and pragmatic dispensation from the obligation to announce — the so-called "down-tools" approach whereby a bidder is entitled to confirm privately to the target that it has already ceased (or will cease, as a result of the requirement to be publicly named) to actively consider making an offer. The target then would be required to make a public announcement to that effect, which would subject the bidder to similar restrictions that would have applied had it released a public "no-intention-to-bid" statement following the imposition of a 28-day deadline. The bidder thereby would avoid public identification, unless there was continued speculation as to its identity or the Panel took the view that identification was required to prevent the creation of a false market.

Recognising concerns that the new rules may deter bidders from approaching targets, the Panel has requested the market's views on whether an alternative approach would be preferable. Under this alternative approach, if a target board believed that it was in the interests of the company for the bidder not to be publicly identified, it would be able to release an announcement confirming an approach had been received, without naming the bidder. The bidder then would be required, within 28 days, to either announce an offer or confirm to the target that it would not be making an offer. In the latter case, the target would release an announcement to that effect, and the bidder would be subject to the same restrictions it would have been subject to if it had announced publicly that it would not bid.

The 28-day deadline may have serious consequences, particularly with respect to the financing of bids and obtaining regulatory clearances prior to announcement. Under the Code, when a cash offer (or one containing a cash element) is announced, the bidder's financial adviser must publicly state that the bidder has the resources required to satisfy full acceptance of the offer. To give such a confirmation, financial advisors require that any lending arrangements be progressed to a "certain funds" stage.

Trade players financing bids with cash on balance sheet likely will have an advantage over bidders (such as smaller trade players and private equity) relying on external funding and subject to more extensive diligence and other requirements imposed by their funding banks. Unless banks are lending against the bidder's balance sheet, bidders funding with debt will be reliant on the target not only to provide information but also, in all likelihood, to extend the 28-day deadline to give them more time to satisfy the banks' diligence requirements. Funding banks will nonetheless be under pressure to accelerate their diligence, credit approvals and marketing to other lenders, and private equity houses with larger funds may need to consider committing more equity at the outset and then refinancing at a later stage.

The shortened time frame also may make it impractical for bidders to obtain regulatory clearances prior to announcement, such that greater stresses will be placed on bid conditions, which (with the exception of UK and EU antitrust conditions) only can be invoked in limited circumstances.

Banning Deal Protections

The Panel has concluded that inducement fees rarely actually induce a bidder to make an offer and that deal protection measures can have the effect of deterring competing bidders, or at least result in competing bids being made on less favourable terms. It therefore proposes to prohibit "any agreement, arrangement or commitment proposed to be entered into . . . in connection with an offer, either

during the offer period or when an offer is reasonably in contemplation." This will remove a number of contractual protections familiar to bidders, such as information and matching rights. Limited exceptions are available for confidentiality, employee retention, provision of information for regulatory purposes, as well as irrevocable commitments and letters of intent to accept an offer given by target directors in their capacity as shareholders. The rules would not restrict the bidder from undertaking any obligations to the target, such as a reverse break fee or standstill agreement.

With respect to schemes of arrangement, which is one of the two principal mechanisms for effecting a takeover in the UK, bidders and targets will be required by the Code to implement a scheme in accordance with a timetable to be agreed upon with the Panel in advance and published in the circular to shareholders, subject to the withdrawal of the target board's recommendation.

The Panel envisages three scenarios in which a dispensation from the general prohibition on such arrangements may be granted, including where a:

- non-recommended offer has been announced and the target wishes to bring in a white knight, in which case the target may be allowed to agree to an inducement fee, subject to the current restriction that it be no more than 1 percent of the competing bidder's offer when it is publicly announced;
- formal sale process is run by a target, in which case an inducement fee (and in exceptional circumstances, other offer-related arrangements) may be entered into at the conclusion of that process when the offer is announced; and
- target is in financial distress and seeking a bidder.

Inducement fees were not a feature of the UK takeover landscape until the late 1980s, due to the perceived effect of certain provisions of English company law that prohibit a target from providing any financial assistance to a bidder in connection with the acquisition of the target's stock. Other contractual protections have become increasingly common in recent years, largely following the adoption of U.S. techniques.

In response to these changes, bidders may reach into the 1980s tool box and resurrect the traditional technique of protecting their position in the event that a competing offer is successfully made for the target — building a stake in target stock. Any such program will need to be considered and planned carefully, given: (i) the "extended composite" disclosure regime now operating under the Code, which operates during an offer period and picks up long and short positions in both the target and a paper bidder; and (ii) the UK Financial Service Authority's Disclosure and Transparency Rules, which operate at all times and require disclosures when shareholdings and holdings of certain financial instruments relating to 3 percent of the voting rights of an issuer (or 5 percent for a non-UK issuer) are acquired.

Other Changes Designed to Improve Disclosure and Recognise the Interests of Employees

A significant number of other changes are proposed, including:

(a) *Bid financing* - financing documents will now need to be put on display, in unredacted form, when a firm offer announcement is made (as opposed to when an offer document is posted, up to 28 days later) and a more detailed description of the financing arrangements will be required in the offer document. The Panel has made it clear that headroom in a financing, which would allow a bid to be increased, need not be described (and hence should be contained in a side letter or other collateral agreement so as not to be put on display). In addition, the Panel will not require granular

descriptions of equity (which may include debt and preferred share capital) provided by funds of the sponsor to private equity bidding vehicles.

(b) *Fees* - the bidder and target will be obliged to disclose an aggregate estimate of advisers' fees, by category, and the bidder will be required to disclose an estimate of financing fees (including up-front, draw-down and commitment fees). Arrangements relating to the variation of fees payable will need to be described, and changes in the expected levels of fees are to be privately disclosed to the Panel (which may require a public announcement).

(c) *Financial information* - recognising that the financial position of the combined group is relevant for the target company and its employees, cash bidders will now be required to disclose the same financial information as paper bidders (the requirement to disclose financial information for the previous three years being reduced to two years). Rather than setting out the information, website addresses of where the information can be found will be sufficient. Cash bidders will not, however, be required to describe material changes to their trading or financial position since the last audited accounts, as paper bidders are required to do. In addition, bidders will have to disclose company ratings and outlook statements published prior to the offer period and describe any subsequent downgrades or changes.

(d) *Statements of intention* - one of the few flowbacks into the Code from the EU Takeovers Directive was the requirement that bidders describe their intentions, among other things, with respect the strategic plans for the target and their repercussions on employment and the locations of business. Bidders will now be required to confirm the absence of such intentions and adhere to all such statements (positive or negative) for a period of 12 months, unless another period is specified. Failure to do so may lead to disciplinary action if the Panel is not satisfied that it was reasonable for the bidder to make the statement. This was the point at issue in Kraft's bid for Cadbury and the two-part reasonableness test articulated by the Panel in that case, which contains both a subjective and an objective element, will apply.

(e) *Employee interests* - to strengthen the ability of employee representatives to provide their opinion on the deal (another Takeovers Directive flowback), a number of changes are proposed: (i) employees of both companies will need to be made aware of the bid when an offer period starts; (ii) the target will be obliged to advise its employee representatives of their right to include their opinion on the deal in the target circular or on the company's website if the opinion is not prepared prior to posting of the circular; (iii) the target will have to meet the reasonable costs of employee representatives in preparing their opinion; and (iv) the Code will clarify that the target can provide information to employee representatives on a confidential basis.

Watch This Space - and Get Ready

We are not yet at the end of this process but, after 14 months, the end is in sight. Bidders considering public offers for UK corporates need to strategize deals now to anticipate the changes.