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Delaware Chancery Court Holds That a Board May Maintain Rights Plan in Face of Tender Offer Deemed Inadequate by Board

In *Air Products and Chemicals, Inc. v. Airgas, Inc.*, and *In re Airgas Inc. Shareholders Litig.*, CA No. 5256-CC, 2011 Del. Ch. LEXIS 1522 (Feb. 15, 2011), Chancellor Chandler considers, in his words "one of the most basic questions animating all of corporate law." – that is, "who gets to decide when and if the corporation is for sale."

As the Chancellor explains, both tender offers and mergers are "extraordinary" transactions. Delaware corporation law requires board approval and recommendation for a merger under DGCL § 251, but no role for the board in tender offers, where a third party offers to purchase shares, subject to obtaining a minimum number (typically a majority) of the outstanding shares. A rights plan, however, gives boards a role in tender offers, allowing the board to defer the closing of the tender offer by threatening significant dilution to a person who acquires shares over the threshold set in the rights plan (typically 15% of the target's outstanding common stock). A board's decision not to pursue a merger is judged under the deferential business judgment standard, "while, on the other hand, a decision not to redeem a poison pill in the face of a hostile tender offer is reviewed under intermediate scrutiny and must be 'reasonable in relation to the threat posed by such offer.'" *Airgas*, 2011 Del. Ch. LEXIS at 35.

The Tender Offer was Not Structurally Coercive

In *Airgas*, the Chancellor held that the Air Products tender offer, on all shares, all cash tender offer, was not structurally coercive, noting that "a structurally coercive offer is one that involves the risk that disparate treatment of non-tendering shareholders might distort shareholders' tender decisions." The Airgas board had more than 16 months to consider the Air Products $70.00 offer and explore strategic alternatives. The Airgas board determined that the Air Products offer was inadequate and elected to pursue Airgas' own strategic five-year plan, announcing that the value of the corporation was at least $78.

Risk of Arbitrageurs Tendering Despite Undervaluing Airgas

The Court acknowledges that "if management advises its stockholders in good faith that it believes [the offer] is inadequate because in its view the future earnings potential of the company is greater than the price offered, [the] stockholders might nevertheless reject the board's advice and tender."*Id*. at 44. Airgas noted that almost half of Airgas stockholders were merger arbitrageurs "willing to tender into an inadequate offer because they stand to make a significant return on their investment even if the offer grossly undervalues Airgas." *Id*. The Court emphasized this risk that "arbitrageurs with no long-

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term horizon would tender *whether or not* they believe the board that $70 clearly undervalues Airgas." (emphasis in original) *Id*. at 45.

Stockholders had Adequate Information

The Court noted that witnesses testified that the stockholders had the information to make a decision. In particular, they knew that three Air Products nominees who were elected to the Airgas board had been skeptical of management's position on value, but changed their minds after they studied the Airgas board's information and heard from management and the board's advisors. The Court noted that the new directors "analyzed the company's business plan under fresh, independent eyes and came to the same determination as the incumbents, which is that the Company's earning potential justifies a sale value of at least $78.00." *Id*. at 46.

Board has Right to Protect Stockholders From Threats

The Chancellor acknowledged that a majority of stockholders might be willing to tender their shares regardless of whether the price is adequate. The Court then applied the Delaware Supreme Court holdings in *Paramount* and *Unitrin*. In *Unitrin*, the Delaware Supreme Court held:

> The directors of a Delaware corporation have the prerogative to determine that the market undervalues its stock and to protect its stockholders from offers that do not reflect the long-term value of the corporation under its present management plan. Unitrin, 651 A.2d 1361, 1376 (citing Paramount, 571 A.2d at 1153).

The Court, citing *Paramount*, explained that when a board is not in *Revlon* mode (having not yet determined to sell the company for cash), the board "is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover." *Airgas*, 2011 Del. Ch. LEXIS at 47.

Thus, the Chancellor concluded that the Airgas board acted in good faith, relying on advice of its financial and legal advisors in coming to the conclusion that Air Products' offer was inadequate, and that in such a case, the board "may properly employ ... a poison pill as a proportionate defensive response to protect its stockholders from a 'low ball' bid." *Paramount*, 571 A.2d at 1150 n. 12.

When are Defensive Measures Preclusive?

The Chancellor determined that Airgas' defensive measures are "not preclusive if they delay Air Products from obtaining control of the Airgas board (even if that delay is significant) so long as obtaining control at some point in the future is realistically attainable." Airgas, 2011 Del. Ch. LEXIS at 50. The Court explains that "realistically attainable" must be something more than a mere mathematical possibility. The court analyses evidence on the ability of Air Products to achieve the two-thirds vote necessary to remove the entire board at a special meeting, and while it does not draw any final conclusion it notes that "the sheer lack of historical examples where an insurgent has achieved such a percentage in a contested control election must mean something." Id. at 52. The Court notes, however, that Air Products could run another proxy contest, where the vote required is significantly less and victory is "very realistically attainable." Id. at 53. The Chancellor therefore concludes that the Airgas defenses are not preclusive. The Court noted that if Air Products was simply unwilling to wait another eight months to run another slate of nominees, that was simply a business decision of the Air Products board, and would not influence the Court's determination as to whether the defense was preclusive. That is, the bidder's expense or convenience is not a factor.

No Duty to Abandon Corporate Plan

The Court notes Air Products' own tactical decision to run a slate of independent directors, promising that its nominees "would consider without any bias the [Air Products] Offer," and that Air Products "*got what it wanted*." (emphasis in original). *Id*. at 55. The Chancellor explains that "inadequate value" is a legally cognizable threat and that directors' fiduciary duty to manage a corporate enterprise includes "the selection of a time frame for achievement of corporate goals. *That duty may not be delegated to the stockholders*." *Paramount*, 571 A.2d 1140, 1154 (Del. 1990) (emphasis added). "Directors are not under a duty to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy." *Id*.

The Court concludes that here the defensive measures fell within a range of reasonableness. The board was "simply maintaining the status quo, running the company for the long term, and consistently showing improved financial results each passing quarter." *Airgas*, 2011 Del. Ch. LEXIS at 55. The Court explains that "directors, when acting deliberately, may follow a course designed to achieve long-term value even at the cost of immediate value maximization." *Id*. at 55, *citing Paramount v. Time*, 1989 WL 79880, at *19 (Del. Cir. July 14, 1989). Although the Court held that the directors of a corporation still owe fiduciary duties to all shareholders, and that therefore duties extend to short-term as well as long-term shareholders, under *Airgas*, a board cannot be forced into *Revlon* mode any time a hostile bidder makes a tender offer that is at a premium to market.

Analysis

The Court answers the question "who gets to decide when and if the corporation is for sale?" Where the board has acted in good faith, after reasonable investigation and reliance on outside advisors, and determines that an offer is inadequate, and posed a legitimate threat to the corporate enterprise, that power resides in the board, not the shareholders.

It is, however, worth noting that Airgas is not a "just say never" case. The Airgas board would have faced a proxy contest had Air Products chosen to proceed. Moreover, the Airgas board had particularly well-developed evidence of future value to compare to the offer from Air Products. Thus, the Airgas board had a business plan from management that multiple independent advisors had scrutinized. The Board, including three independent directors nominated by the hostile bidder, concluded, acting in good faith, that this business plan was reasonably achievable, and offered long-term value significantly in excess of the premium bid by Air Products. Airgas was achieving its plan and financial results were improving, even in the face of the recession. These unusually favorable facts supported the board's determination to maintain its defenses.

Thus, absent such favorable facts, the Court may well have concluded that there was no threat of an inadequate offer or that the continued maintenance of the rights plan was not a reasonable response. For example, we do not know how the Court would have assessed the reasonableness of the board's decision not to redeem the rights plan if the value of the Company under the strategic plan was only somewhat greater than the offer — *e.g.*, $74 instead of $78 versus the $70 bid. Or said differently, was the clear inadequacy of the offer essential to the Court's decision? Further, many companies may not have the record of consistently improving financial results enjoyed by Airgas, but their boards might still feel a hostile offer is undervaluing the target's prospects, based on an optimistic, but potentially achievable operating plan. We do not know what evidence of future value, short of the Airgas facts, will be deemed sufficient to give a board the reasonable belief in the inadequacy of a hostile bid.

> *The Chancellor explains that "inadequate value" is a legally cognizable threat and that directors' fiduciary duty to manage a corporate enterprise includes "the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders."*

Nonetheless, the *Airgas* decision unambiguously supports the ability of a Delaware board acting in good faith, and after reasonable investigation and reliance on experts, to determine whether and when a company is for sale, and to take reasonable steps to protect the shareholders from an inadequate bid. That is a welcome decision for boards who are using their business judgment to maximize shareholder value.

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Disclosure Of Litigation Contingencies

At a New York Bar Association conference held on January 28, 2011, the Chief Accountant of the SEC's Division of Corporation finance, Wayne Carnall, warned registrants against relying on the long standing "treaty" between lawyers and accountants with respect to reporting litigation contingencies in financial statements. In preparing public disclosures, Mr. Carnall asked that registrants and their lawyers look past what a registrant reported in the prior year or in auditor inquiry letters and carefully comply with the standards set forth in Accounting Standards Codification 450-20 (formerly known as Financial Accounting Standard No. 5). This statement is consistent with the interpretive positions advanced by the Staff over the past six to nine months in various comment letters.[1]

ASC 450-20 currently requires the disclosure of a litigation contingency if there is a "reasonable possibility" that a loss has been incurred. Registrants are to evaluate whether a loss from litigation is "probable," whether the amount of loss can be "reasonably estimated" and where the loss is both probable and can be reasonably estimated, to accrue an appropriate amount. The principle itself has not changed, although registrants have been placed on notice that reliance on the "treaty," which seeks to preserve attorney-client confidences when disclosing the amount of potential loss from a litigation to auditors, in the absence of confidence in such an estimate, is in jeopardy. The long standing position of the American Bar Association is reflected in its 1976 *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*:

> Concepts of probability inherent in the usage of terms like 'probable' or 'reasonably possible' or 'remote' mean different things in different contexts ... as a general rule, it should not be anticipated that meaningful quantifications of 'probability' of outcome or amount of damages can be given by lawyers in assessing litigation ... the lawyer may be asked to estimate the potential loss (or range) in the event that an unfavorable outcome is not viewed to be 'remote.' In such a case, the lawyer would provide an estimate only if he believes that the probability of inaccuracy of the estimate of the range or amount is slight.

Typically, registrants have relied on this "treaty" in refraining from estimating potential losses in the absence of certainty. However, in response to requests for more timely and transparent disclosures about loss contingencies, Mr. Carnall warns that registrants have an obligation to comply with GAAP and that reliance on the "treaty" is not a defense. In July 2010, the FASB issued a proposal to expand loss contingency disclosures to include certain remote loss contingencies and generally increase disclosure requirements.[2] Faced with concerns from its constituents, the FASB has instead given the SEC the opportunity to attempt to improve compliance with existing disclosure requirements before moving forward with this proposal.

Practice Points

This issue is particularly important because it involves the need to balance the accuracy of disclosures that a registrant makes to the public, while at the same time maintaining the registrant's ability to achieve the best possible result for itself and its equity owners with respect to any particular litigation. In disclosing an estimate of damages to the public, registrants are rightfully concerned that this degree of transparency may be used by a registrant's adversary to establish a floor in settlement discussions or even constitute self-created evidence against the registrant.

With the foregoing in mind, registrants may continue to state that estimates cannot be provided with any "certainty" or "confidence," however, they should be aware, that if settlement discussions are disclosed at a later date, the SEC may bring past disclosures regarding such litigation, or the lack of such disclosure, into question. With this in mind, registrants should be careful to consider the reporting requirements of ASC 450-20 and to the extent that a registrant does not disclose a range of possible loss, it should be prepared to defend that decision at a later date.

The principle itself has not changed, although registrants have been placed on notice that reliance on the "treaty," which seeks to preserve attorney-client confidences when disclosing the amount of potential loss from a litigation to auditors, in the absence of confidence in such an estimate, is in jeopardy.

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[1] See Comment Letter from Kevin Woody, Branch Chief, Division of Corporation Finance, SEC, to Steven P. Grimes, Chief Executive Officer, Inland Western Retail Real Estate Trust, Inc. (October 21, 2010); Comment Letter from Kevin Woody, Accounting Branch Chief, Division of Corporation Finance, SEC, to Peregrine C. Broadbent, Executive Vice President and Chief Financial Officer, Jefferies Group, Inc. (July 27, 2010); and Comment Letter from Amit Pande, Accounting Branch Chief, Division of Corporation Finance, SEC, to Richard J. Johnson, Chief Financial Officer, The PNC Financial Services Group, Inc. (June 24, 2010).

[2] Proposed FASB Accounting Standards Update, *Disclosure of Certain Loss Contingencies*, issued July 20, 2010.

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Dodd-Frank Executive Compensation Clawbacks: Action Items and Open Issues

The Dodd-Frank Wall Street and Consumer Protection Act, passed in 2010, requires all public companies to implement a clawback policy for incentive compensation paid to executive officers as a condition to being listed on a securities exchange. The clawbacks will be triggered in the event of any accounting restatement resulting from material noncompliance with financial reporting requirements, regardless of whether there is any misconduct involved. Although the clawback requirements will not become effective until the Securities and Exchange Commission issues guidance — which is expected by December 2011 — there are a number of issues companies should be considering in the meantime.

Background

Prior to 2002, clawbacks were used relatively infrequently in the executive compensation arena. The Sarbanes-Oxley Act of 2002 ("SOX") altered the landscape by requiring publicly traded companies to recoup certain incentive compensation paid following an accounting restatement that results from material non-compliance, due to misconduct, with financial reporting requirements under the securities laws. The SOX clawback requirements are rather narrow in scope, as they apply only to amounts received by the CEO and CFO within the one-year period following the misstated financial statement, and only where there was misconduct resulting in the financial statement deficiencies.

Public companies will soon be required to implement a clawback policy that is significantly broader than the clawback required by SOX. Under Dodd-Frank, in the event of an accounting restatement due to material non-compliance with financial reporting requirements under the securities laws, companies will be required to recover certain "excess" incentive compensation from any *current or former executive officer* who received "incentive-based compensation" during the *three-year period* preceding the date on which the company is required to prepare an accounting restatement. The "excess" incentive compensation that must be recovered is the difference between the amount of incentive compensation the executive officer would have received under the restated financials and the amount of incentive compensation received under the original, erroneous financials. Companies will also be required to ensure that the clawback policy provides for a mechanism to disclose all incentive-based compensation that is based on financial information required to be reported under the securities laws.

The clawback requirements under Dodd-Frank are significantly broader than under SOX in several respects. For one, clawbacks under Dodd-Frank extend to incentive compensation paid during the three years prior to the date the company is required to prepare the accounting restatement, whereas SOX clawbacks apply only to incentive compensation paid during the one-year period following the date of the misstated financial statement.

Additionally, all current and former "executive officers" must be covered by the clawback policy under Dodd-Frank. Although the term "executive officers" is not defined by the statute, it will almost certainly be a larger group than covered by the SOX clawback requirements, which apply only to the CEO and CFO. A third difference between Dodd-Frank and SOX is that the Dodd-Frank clawback applies to financial restatements for any reason — for example, a borderline interpretation of GAAP — while SOX covers only restatements due to misconduct. Given these significant differences, it is likely that companies with existing clawback policies will need to overhaul those policies for Dodd-Frank.

Open Issues

There are a number of open issues that the SEC will presumably address with its regulations, including the definition of "executive officers" as explained above. What follows is a list of some of the more interesting issues left open by the statute.

1. *Unilateral Policy versus Bilateral Agreements.* The statute imposes an affirmative duty upon companies to recover excess incentive compensation but is silent as to whether the executive officer must consent to the clawback. Applying this rule literally, companies may be required to recover amounts that they are not contractually entitled to recoup. For example, most employment agreements provide that bonuses are vested once earned and, therefore, may not contractually be recovered. Similarly, mutual releases of claims entered into with departing executives presumably bar the company from asserting any claims to recover compensation. The regulations will need to address whether companies can unilaterally implement a clawback policy or whether they must obtain the executive officers' consent.

2. *Retroactivity.* One of the more significant issues left open by the statute is whether the clawback requirements will apply retroactively to incentive compensation awards granted or paid prior to the effective date of the regulations. Along those lines, if the regulations do provide for retroactive application, it is unclear whether executive officers whose employment terminates before the regulations become effective will be subject to the clawback requirements. The regulations will also presumably address whether an individual who was not an executive officer at the time of an award of incentive compensation, but who becomes an executive officer prior to an accounting restatement, is subject to the clawback requirements.

Another open issue is how companies can effect clawbacks with respect to equity awards: presumably a company would be required to recover the cash amount derived from sales of equity interests from the executive officers, but will they be required to cancel unvested or unexercised vested awards?

3. *Equity and Equity-Based Awards.* Equity and equity-based incentive compensation awards present a number of issues open to interpretation under the statute. For example, the statute generally does not provide guidance as to the meaning of "incentive-based compensation." However, it does reference stock options as one type of "incentive-based compensation." The regulations could adopt a narrow definition of "incentive-based compensation" that excludes purely time-based stock options and restricted stock (*i.e.*, limit the clawback only to performance-based compensation). Another question is whether equity-based awards that were granted based on reported metrics, but which have not yet vested, will be considered "received" under the statute and therefore subject to the clawback requirements? And when are awards valued for purposes of determining excess compensation? Perhaps the rules will compare the value at the date of grant, or alternatively immediately prior to the announcement of the restatement (when the markets presumably have not priced in the accounting discrepancy), to the value

immediately following the restatement or some other time? Another open issue is how companies can effect clawbacks with respect to equity awards: presumably a company would be required to recover the cash amount derived from sales of equity interests from the executive officers, but will they be required to cancel unvested or unexercised vested awards? The SEC will need to address each of these issues and many more relating to equity-based compensation.

4. *Indemnification Obligations.* It is common practice for public companies to provide for indemnification of executives for certain costs incurred by the executive in defending against or settling a lawsuit, provided certain good faith requirements are met. As Dodd-Frank clawbacks are not limited to restatements due to misconduct, these indemnification provisions could potentially cause a company to be legally obligated to repay an executive officer for amounts the company recovers under its clawback policy. Companies could go a step further and enter into indemnification agreements specifically covering any amounts recovered under a clawback policy. As these agreements would undermine the purpose of the statute, and would be against public policy, the SEC will presumably need to address how Dodd-Frank will impact these arrangements.

5. *Wage Laws*. Clawbacks under Dodd-Frank could potentially violate applicable state wage payment laws or similar foreign laws. Although many state laws exempt incentive compensation, companies should be prepared to perform a review of the laws in the applicable jurisdictions once the regulations are implemented. Presumably, Dodd-Frank, as a federal statute, will preempt state wage payment laws, but this is not certain.

6. *De Minimis Clawbacks*. As drafted, the statute does not permit companies to forego a clawback in cases where the "excess" incentive compensation paid is *de minimis* or if the costs of recovery would exceed the recoverable amount. Whether the regulations will permit exceptions under these scenarios remains to be seen.

Action Items

Given the uncertainties noted above and the many other issues left open by the statute, we recommend waiting until the regulations are implemented prior to establishing, or amending, a clawback policy to comply with Dodd-Frank. That said, there are several steps companies should be taking now in order to avoid potential roadblocks down the road.

1. *Inventory of Incentive Compensation Plans.* Companies should take an inventory of all plans, programs and agreements that provide for incentive compensation tied to financial metrics. Most commonly, this group would include short- and long-term performance plans such as equity plans and bonus plans. However, the definition is broad enough that employment agreements, severance agreements and change in control agreements may also include compensation provisions that are subject to the clawback requirements. All such agreements should be reviewed to avoid a rush to meet the deadlines that will be imposed by the regulations. As part of this review, companies should also consider whether a clawback could potentially give an executive "good reason" to terminate his or her employment agreement.

As Dodd-Frank clawbacks are not limited to restatements due to misconduct, these indemnification provisions could potentially cause a company to be legally obligated to repay an executive officer for amounts the company recovers under its clawback policy.

2. *Individual Letter Agreements*. Companies should consider requiring, as a condition of continued employment, that all executive officers enter into form letter agreements with the company, which provide that all incentive compensation paid to the executive be subject to the requirements of Dodd-Frank as well as the company's clawback policy as in effect from time-to-time. These agreements would give the company a contractual right to effect the clawback requirements of Dodd-Frank on both a retrospective and prospective basis. Additionally, the agreements would allow companies to take a wait-and-see approach before implementing a policy that complies with Dodd-Frank and give companies significant flexibility to amend their policies in the future to reflect changes in their philosophy on clawbacks. These letter agreements could be effected prior to the implementation of the regulations to protect against the possibility of an executive officer leaving a company's employ before the company obtains a contractual right to effect the clawback. In lieu of individual agreements, clawback language could, potentially, be inserted into each covered incentive

compensation plan, program or agreement, although this would presumably be a more difficult and expensive task to accomplish given the many types of compensation arrangements that are covered by the statute.

Additionally, all current and former "executive officers" must be covered by the clawback policy under Dodd-Frank. Although the term "executive officers" is not defined by the statute, it will almost certainly be a larger group than covered by the SOX clawback requirements, which apply only to the CEO and CFO.

3. *Releases.* As alluded to above, another issue that should be considered prior to the implementation of the regulations is the impact of the clawback requirements on releases of claims. An employment agreement or severance agreement may require that as a condition to receiving severance benefits the executive execute a mutual release of claims with the company. Given that such agreements would include a release by the company of all claims relating to compensation paid to an executive officer, the company may be contractually barred from effecting a clawback. Therefore, on a going-forward basis, companies should consider providing a carve-out in their releases for incentive compensation covered by Dodd-Frank. In addition, companies should review employment agreements and severance agreements for all executive officers whose employment has terminated in the last three years to assess whether the company has released claims relating to compensation that the company may be required to clawback. If there are such agreements, the company may be required to provide additional consideration to the departed employee in order to effect a clawback.

4. *Clawback Specifics*. As Dodd-Frank provides a floor, rather than a ceiling, of clawback requirements, companies should consider whether to implement a broader clawback policy than required by Dodd-Frank. For example, a company may wish to have the clawback policy apply to a larger group of executives than the "executive officers" to be identified by the SEC. Similarly, companies may wish to have a clawback triggered in circumstances other than misstated financial reports, such as in the event of termination for cause or breach of a restrictive covenant. Given the resources that companies will expend in creating and administering the clawback policy, companies should take the time now to consider whether the clawback should address broader goals than meeting the minimum requirements of Dodd-Frank.

5. *Evaluate Compensation Structures*. Companies should evaluate their existing compensation structures in light of the challenges presented by the clawback requirements. For example, companies may decide to impose three-year vesting periods to ensure a smooth recovery in the event a clawback is triggered. Alternatively, companies may wish to consider shifting compensation away from incentive compensation tied to financial metrics to other types of performance metrics that are not covered by the clawback requirements.

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Proposed Reform of U.K. Takeover Regulation in Light of Experience of the Offer for Cadbury plc

Background

On March 21, 2011, the Code Committee of the U.K. Panel on Takeovers and Mergers ("Panel") published its consultation paper on proposed amendments to the City Code on Takeovers and Mergers ("City Code"). This follows a debate triggered by the bid by Kraft Foods Inc, for Cadbury plc, on whether the U.K. takeover rules make it too easy for a hostile bidder to gain control of a U.K. public company. The consultation paper proposes a number of detailed rule changes with a deadline for comments of May 27, 2011. There is no fixed timetable for implementation, though the changes may take effect as early as the summer.

The principal changes proposed include:

- a requirement (subject to limited exceptions) to name a potential offeror in any announcement required under the City Code as to a possible offer and to require in those circumstances that a potential offeror within 28 days makes a further announcement either of its firm intention to make an offer or its decision not to proceed with any offer;
- a general prohibition (except in limited circumstances) on deal protection measures and inducement fees binding on an offeree company;
- disclosure in the offer documentation of an estimate of the fees of the offeror and the offeree company together with a breakdown by category of adviser, namely, financial advisers and corporate brokers, accountants, lawyers and public relations advisers;
- disclosure in greater detail of the financing facilities used to implement an offer, namely any debt facilities or other instruments entered into in order to finance the offer and/or to refinance the existing debt or working capital facilities of the offeree company; and
- increased emphasis on the need for disclosure by an offeror of its intentions with regard to strategic plans for the offeree company including their likely repercussions on employment and the locations of the offeree company's places of business and its intentions generally regarding the management and employees of the offeree company. This will include a requirement that an offeror be held to any statement made in its offer document or otherwise during the offer period with regard to such matters for a period of at least 12 months.

Further details of these and related proposals set out in the consultation paper are discussed below.

Principal changes

1. **Increased protection for an offeree against protracted virtual bid periods.**

   There are a number of proposed modifications to the current "put up or shut up" regime originally intended to protect companies from a possible "siege" by an unwelcome potential offer or:

   a A requirement in the announcement that commences an offer period, to name the potential offeror irrespective of who makes the announcement

   b. Within 28 days following the date upon which the potential offeror is publicly named, a publicly named potential offer or must:

   i. announce a firm intention to make an offer;
   ii. announce that it will not make an offer; or
   iii. make a joint application with the offeree for an extension of the deadline and if successful, announce the revised deadline for an announcement of a firm intention to make an offer

   These changes are expected to mean that a prospective offeror will exercise greater care in maintaining confidentiality so as to avoid rumor and speculation and the possibility of any untoward movement in share price that might give rise to the need for an announcement identifying the potential offeror by name. Also, quite apart from the 28-day deadline, it is likely to mean that in most cases a potential offeror will be under pressure from an offeree company to conclude quickly whether it is prepared to announce a firm intention to make an offer, with possible implications for the nature and extent of the due diligence that it may be able to undertake in reaching that decision.

   Exceptions from the general rule, include the following:

   i. A formal sale process where the offer period commences with an announcement that the offeree company is seeking one or more potential offerors by means of a formal sale process. In such a case a potential offeror who agrees to participate in that process and in respect of whom an announcement is subsequently made would not be required to be publicly identified and would not be subject to the 28-day deadline.
   ii. Where an announcement would otherwise be required as a result of rumor or speculation concerning an offer, the potential offeror will, if the Panel and the offeree so agree, be able to avoid being identified in a public announcement by ceasing all active consideration of the offer for a period of six months.

2. **Prohibition on deal protection measures and inducement fees other than in certain limited cases.**

   The Panel is concerned that it has become common to negotiate inducement fees and similar arrangements with offeree companies and that this has potentially detrimental effects for offeree company shareholders in that they might deter competing offerors from making an offer and/or cause competing offerors to make an offer on less favorable terms than they would otherwise have done. The Panel therefore proposes to amend the City Code to include a general prohibition (save in certain limited circumstances) on deal protection measures and inducement fees.

   There is no fixed timetable for implementation, though the changes may take effect as early as the summer.

   Certain arrangements will be excluded from the general prohibition as follows:

   a. Agreements or arrangements that impose obligations only upon an offeror or persons acting in concert with it e.g., a reverse break fee.

   b. Limited obligations to maintain the confidentiality of information, not to solicit the offeror's employees, customers or suppliers and to provide such assistance and information needed to satisfy offer conditions or certain regulatory approvals.

   c. Irrevocable commitments and letters of intent to accept an offer given by the directors of the offeree company acting in their personal capacities as shareholders in the offeree company or by other shareholders who are, or who are presumed to be, acting in concert with the offeree company.

   Provision is also to be made for further limited exceptions as follows:

a. Where following a hostile offer, a single preferred competing offeror ("white knight") emerges and an inducement fee arrangement is proposed with that single competing offeror, provided the value of the inducement fee is not more than 1% of the value of the offeree company calculated by reference to the competing offeror's offer at the time it is announced.

b. Where the offeree company has initiated a formal process to sell the company by means of a public auction, it will be able to enter into an inducement fee arrangement at the conclusion of that process with one offeror who participated in the process, provided that the value of the inducement fee is not more than 1% of the value of the offeree company calculated by reference to the offeror's offer at the time it is announced.

In practice, the Panel may also derogate from the general prohibition where the offeree company is in financial distress, although it is not proposed to include in the City Code any specific provision in respect of such an exception.

More generally, it seems likely that the prohibition on deal protection measures and inducement fees may have the greatest potential impact on private equity bidders, who will no longer be able to rely on an inducement fee as a means of covering or helping to cover the costs of an unsuccessful offer.

3. **Proposals aimed at increasing transparency and improving the quality of disclosure.**

   a. Advisers and financing fees.

      i. Each of the parties to an offer will be required to set out an estimate of their aggregate fees in the offer document or (in the case of an offeree) its first defense document together with a breakdown of the estimated fees by category of adviser, namely, financial advisers and corporate brokers, accountants, lawyers and public relations advisers.

      ii. An offeror will be required in addition to separately disclose the fees and expenses expected to be incurred in relation to the financing of the offer.

   If during the course of an offer the estimated fees in aggregate or in a particular category should increase beyond what has been publicly disclosed or if by the end of the offer the final fees and expenses are greater than what has been publicly disclosed, this would have to be privately disclosed to the Panel, who, if it thinks fit, will require public disclosure of the revised estimate or of the final fees and expenses.

   b. Financial information on offeror and offeree companies.

      i. Currently, an offeror making a cash offer is normally required to provide less financial information on itself than would be the case if the consideration were comprised of securities in the offeror. The Panel has however, concluded that various stakeholders in an offeree company will have an interest in the financial position of the offeror, even in the case of a cash offer and therefore the same level of financial information should be disclosed for all offers. It will be possible to discharge this obligation by the inclusion in the offer document of a reference to a website address where the audited accounts and interim and preliminary statements of results for the last two years have been published.

      ii. A concession for a cash offeror, however, is that it will not be required to include in its offer document details of any material changes to its financial or trading position since the publication of its last audited accounts. The reason is that the Panel understands that the costs involved in assessing whether there have been any material changes can be quite considerable, whereas the benefit of such a statement in the context of a solely cash offer is felt to be marginal.

      iii. The Panel remains of the view that an offer document should contain details of the ratings and outlooks publicly accorded to the offeror and offeree companies prior to the commencement of the offer period, any changes in those ratings and outlooks during the offer period and prior to the publication of the offer document and a summary of the reasons given, if any, for any such changes.

iv. Offerors will be required to disclose a greater level of detail about the financing facilities used to implement the offer. Details will be required of the debt facilities or other instruments entered into in order to finance the offer and to refinance the existing debt or working capital facilities of the offeree company, including the amount of the facility or instrument, the repayment terms, interest rates, and names of the principal financing banks. However, it will not be necessary to disclose any headroom that may exist under the financing arrangements in order to finance any revised offer. Also, the Panel accepts that the structures by which equity is provided to private equity offeror vehicles may be commercially sensitive and so it will not require such equity structures to be disclosed in detail and in particular it will not be necessary to drill down within the private equity funds themselves.

More generally, it seems likely that the prohibition on deal protection measures and inducement fees may have the greatest potential impact on private equity bidders, who will no longer be able to rely on an inducement fee as a means of covering or helping to cover the costs of an unsuccessful offer.

4. **Providing greater recognition of the interests of employees**

a. *Disclosure of the offeror's intentions regarding the offeree company and its employees.*

i. An offeror will be required to state in the offer document its intentions with regard to the future business of the offeree company and explain the long term commercial justification for the offer. In addition, the following matters will need to be addressed:

- the offeror's intentions with regard to the continued employment of the employees and management of the offeree company;
- the offeror's intentions with regard to any material change in the conditions of employment of the employees of the offeree company;
- the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the offeree company's places of business;
- the offeror's intentions with regard to any redeployment of the of the fixed assets of the offeree company; and
- the offeror's intentions with regard to the maintenance of any existing trading facilities for the relevant securities of the offeree company.

ii. The Panel proposes that an offeror should be held to any statement made in the offer document in relation to any of the matters referred to in paragraph i above or otherwise made during the offer period in relation to any course of action it intends to take or not take (as the case may be) for a period of at least 12 months or such other period as may be stated by the offeror at the time the statement is made. This change is largely in response to the conduct of Kraft Foods Inc., in relation to statements it made concerning its intentions regarding the business of Cadbury plc.

b. *Improving the ability of employee representatives to make their views known on an offer.*

The Panel considers that the City Code should be amended to improve communication between participants in an offer and their respective employees and employee representatives, and in that connection it is proposed that:

i. it should be made clear that the City Code does not prevent the passing of information in confidence in an offer period to employee representatives acting in their capacity as such;

ii. an offeree company board should be required to inform its employee representatives at the earliest opportunity of their right to circulate an opinion on the effects of an offer on employment; and

iii. it should be made clear that the offeree company's board has a responsibility to publish the employee representatives' opinion at the offeree company's expense.

c. *When to notify employees that an offer is being made.*

It is proposed that the point in time at which the offeror and offeree companies should notify their employees that an offer is being made should be brought forwards to the date of commencement of an offer period, even if that date is prior to the announcement of a firm intention to make an offer. In addition, the employee representatives or, if there are no employee representatives at that time, the employees themselves, should be reminded of the right for the employee representatives to have a separate opinion on the offer and for this to be circulated (as described above).

d. *Impact*

The effect of the increased emphasis on the participation of employee representatives in the bid process is difficult to gauge, though early thought will need to be given to the approach to dealing with the employees as part of the process of planning a bid. In addition, a potential offeror will need to give careful thought as to any statements it makes during the course of an offer as to its intentions with regard to the employees of the offeree company and any strategic plans for the business of the offeree company and their effect on employment. Given the possibility that there will be an obligation to adhere to any statement for a period of 12 months after the date upon which the offer becomes or is declared wholly unconditional, it may be that offerors will develop anodyne or non-committal wording from which it is very difficult to extract any clear meaning at all, which would rather frustrate the objective of improving the quality of disclosure in this area.

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