AN EXPLORATION OF WHETHER THE SUBSTANTIVE LAW GOVERNING CORPORATE TAKEOVERS IN THE UK IS EFFECTIVE IN ACHIEVING EQUALITY OF TREATMENT FOR SHAREHOLDERS

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ABSTRACT

Takeover regulation in the UK has historically been shareholder-centric and shareholder primacy has been the core principle of UK's takeover regulation. This article primarily examines the substantive law governing corporate takeovers in the United Kingdom and critically analyses whether the substantive law is effective in achieving equality and fair treatment of all shareholders involved in the takeover. This is followed by an exploration of the safeguards in place which ensure real time minority shareholder protection and the relating case law which further bolster the development of the law by providing clarity on certain issues relating to the safeguards. Furthermore, the article also analyses the proposed amendments and suggestions to the current UK regime. The proposed amendments that are examined consist mainly of the amendments and arguments discussed in the Takeover Panel's Consultation paper which was published after Kraft Food Inc.'s controversial takeover of Cadbury Plc in 2010.

INTRODUCTION

The first part of this article examines the substantive law governing corporate takeovers in the United Kingdom and critically analyses whether the aforementioned substantive law is effective in achieving equality and fair treatment of all shareholders involved in the takeover. It argues that takeover regulation in the UK has historically been shareholder-centric and shareholder primacy has been the core principle of UK's takeover regulation. The level of minority shareholder protection available in a takeover bid is examined in detail by initially analysing the protection offered to minority shareholders by the combination of the rules enshrined in the City Code (and subsequently the Takeover Code). This is followed by an exploration of the safeguards in place which ensure real time minority shareholder protection and the relating case law which further bolster the development of the law by providing clarity on certain issues relating to the safeguards. Some of the safeguards explored include: Mandatory Bid rule, Squeeze-out and Sell-out rights, Director's duties and Information disclosure.

However, in order to effectively understand the level of protection offered to UK's minority shareholders, the regulations and protections offered by other major jurisdictions need to be considered. Therefore, the protection offered to minority shareholders during takeovers within the EU legal framework is compared and contrasted where the argument that unlike the case in UK, at the EU level, minority protection is merely a requirement for achieving an objective which is to 'prevent patterns of corporate restructuring within the Community from being distorted by arbitrary differences in governance and management cultures'[i] and the 'Takeover Directive's protection of minority shareholding is nothing more than being merely incidental to the objective of facilitating EU-wide corporate restructuring'[ii] is briefly considered. Based on the observations, the article argues that the UK system is superior as it ensures equal treatment of all target shareholders.

The second part of this article examines the proposed amendments and suggestions to the current UK regime. The proposed amendments that are examined consist mainly of the amendments and arguments discussed in the Takeover Panel's Consultation paper which was published after Kraft Food Inc.'s controversial takeover of Cadbury Plc in 2010. The essential case facts which are relevant to the proposals have been considered in order to eliminate any potential ambiguity. Furthermore, the Panel declined a number of proposals relating to modification as it felt that those proposals were not appropriate at the current time. However, these proposals are not going to be considered in this article.

THE PRIMACY OF SHAREHOLDER PROTECTION IN UK TAKEOVER LEGISLATION

City Code and Shareholder Equality

From the very beginning, the concept of safeguarding the interests of shareholders has been the most crucial aspect of UK takeover regulation. In the late 1950s, English company law was unable to assist and protect the interests of aggrieved minority shareholders as directors who frustrated the bids could not be challenged as directors owe their duties only to the company and not the shareholders.[iii] Therefore, in October 1967, a drafting committee formulated a draft "Code" which consisted of ten "General Principles" and 35 rules and came into effect later on the 27th March 1968 following completion of all the necessary approvals and amendments by the different associations. Even though this City Code (City Code on Takeovers and Mergers) has been amended multiple times since its inception, the key provisions have not been altered in substance.[iv] The UK takeover regulation has set up numerous measures to ensure shareholder protection. Furthermore, it is interesting to note that these provisions had a negligible effect from the aftermath of UK's implementation of the Takeover Directive in 2006.

The most crucial principle of the City Code, found in its first General Principle is the concept of shareholder equality. This principle is so fundamental that it is enshrined in the Takeover Directive of 2004.[v] Furthermore, this principle was 'central to UK takeover legislation long before the Takeover directive required implementation'.[vi] The City Code ensures that the same offer is to be made to all shareholders of the same class[vii]; if the target company has multiple classes of equity share capital; a "comparable" offer is to be made to each class irrespective of whether or not a particular class carries voting rights.[viii] The City Code also attempts to prevent the bidder from executing mutually-beneficial deals with specific shareholders either before[ix] or during the offer period.[x] Lastly, the City Code contains provisions that ensure that the target shareholders are well-informed and have sufficient information based on which they can make their decision[xi] while also having enough time within which to reach a decision.[xii] The target shareholders who accepted the original offer from the bidder are entitled to the revised consideration.[xiii]

Mandatory Bid Rule

To safeguard minority shareholders from unfair practices prevalent during a takeover bid, takeover regulation has put in place the mandatory bid rule (MBR). This rule primarily has two aims: to prevent arbitrary control on acquisition and to prevent unfair treatment of minority shareholders during acquisition.[xiv] The mandatory bid rule originated in the UK and now applies in many other jurisdictions including the EU. Under this rule, an 'acquirer of a controlling stake (the bidder) in a listed company has to offer to the remaining shareholders a buy-out of their minority stakes at a price equal to the consideration received by the incumbent controller'.[xv] This essentially means that any entity which obtains "control" over a listed company is under an obligation to make an offer to all the remaining shareholders of the target company in order to obtain the residual shares.[xvi] An entity is deemed to have "control" if it triggers the set threshold of voting rights, which is 30 per cent in the UK[xvii] and most Member States. Furthermore, the bidder needs to offer all of the remaining shareholders an "equitable" price, which is basically a price equal to the highest price the bidder paid for shares of the target company during a specified period of time (which spans between six to twelve months depending on the Member State; twelve months in the UK).[xviii] Additionally, this "equitable" price rule is the reason for the MBR being called the 'equal opportunity rule'[xix], this is because the bidder needs to treat all shareholders the same as he needs to offer an equal price for their shares. Therefore, when the bidder obtains a block of shares from the "controlling" shareholder, the remaining shareholders are effectively 'tagged-along' and have an equal opportunity to dispose their shares. In this regard, MBR safeguards the minority shareholders by ensuring they receive the control premium.

On the other hand, the MBR has been subject to a plethora of criticism, a major segment of this criticism is economic criticism of the mandatory bid. Critics have four main economic objections to this rule.[xx] Firstly, Mandatory bids encourage "artificial interference" throughout the market in relation to corporate control. The market can effectively function without mandatory bids and the bidder could increase the bid price so that it corresponds to the control premium set by the controlling shareholder of the target company and this price need not be offered to the minority shareholders. Secondly, the MBR in general makes the entire process of takeovers more difficult as it leads to takeovers becoming costlier. This may discourage potential bidders and competitive bidders from placing bids in the first place resulting in desirable takeovers not taking place. Thirdly, the most important feature of mandatory bids which is the protective function is not achieved as mandatory bids can easily be circumvented by off-market block transactions and other methods such as structural measures (for example: mergers) and by 'voluntary lower bids at a strategically chosen favourable time (low balling, creeping in).'[xxi] Lastly, mandatory bids are specifically meant for listed companies, this may encourage company founders and shareholders to avoid listing the company in the stock market itself. This could be potentially harmful for the public investors and the market for corporate control.

Furthermore, bidders who are unable to or do not wish to pay the highest price paid in a specified time period may use a loophole which is neither addressed by the City Code nor the Takeover Directive as implemented by the Companies Act 2006. Bidders would just have to stagger the acquisition beyond the specified time period (which is twelve months). This is seen in the case of *Gilgate Holdings Ltd*,[xxii] where parties bought twenty-nine per cent of the shares from the target company at 22.5 pence per share, and after twelve months and one day they bought more shares (around seven per cent) at a meagre 8.75 pence per share. The mandatory bid, on its application, required the parties to pay only 8.75 pence per share as it was the highest price paid for the share in the last twelve months, effectively, defeating the mandatory bid principle.

Squeeze-out and sell-out rights

The squeeze-out and sell-out rights are safeguards built into takeover legislation for the protection of minority shareholders. For either of these rules to apply, the bidder has to acquire at least 90 per cent of the shares of the target company. The squeeze-out rights[xxiii] enable the successful bidder to compulsorily buy out the shares of the remaining minority shareholders (ten per cent) who have not accepted the bid. However, the bidder is obliged to buy the shares on the final terms of the offer[xxiv] and the minority shareholders can object, by application to the court.[xxv] Sell-out rights[xxvi] enable the minority shareholders (holding the remaining ten per cent) to force the successful bidder to buy out the remaining shares. Furthermore, the sell-out rights are designed in such a way that rights not only allow the minority shareholders to exist in the company but also have the option to be bought out at the offer price.[xxvii] However, it is necessary to bear in mind that implementation of these rules involve procedures which may consist of compulsory sale or acquisition of the shares against the will of the holder or the acquirer. As a result, higher thresholds apply to the exercise of these rights and there are additional protective rules on the price that is to be paid for the acquisition of the shares.[xxviii] The procedures can be challenged in court, which maximises fairness and ensures that the minority shareholders are not subject to unfair treatment by either the "controlling" shareholders or the successful bidder.

As seen with the mandatory bid rule, safeguards are often subject to heavy criticism. Critics have argued that even though squeeze-out rights have been part of UK company law, these rights not only infringe minority rights, but also renders minority shareholding an illusory right.[xxix] The regulations only cater for only the financial interest of the minority, whilst 'averting the danger of hampering the efficiency of the market for corporate control'.[xxx] Based on the current scenario, one gets the impression that the squeeze-out right of a successful bidder (who has obtained 90 per cent of shares carrying voting rights) cannot be defeated on the basis that the minority shareholder refuses to sell his shares to the bidder.

Three connecting arguments can be made to support this claim: Firstly, the UK Courts seem to only look at cases involving resistance of compulsory purchase under the squeeze-out rights when the grounds of the application was that the offer was unfair. This is seen in the case of *Re Bugle Press Ltd* [xxxi] where the majority shareholders of Bugle Press Ltd formed a new company and sought to buy the remaining 1000 shares from the remaining shareholder (T). When T refused on the ground that the price was too low, the offeror gave T a notice of intention to purchase his holding compulsorily under Companies Act 1948, s 209. The Court of Appeal held that the scheme was not binding on T. However, it is seen that courts have not favoured such applications.[xxxii] Secondly, when the courts decide to review an application, the onus is on the minority shareholder to prove that the offer was unfair. In the case of *Re Gierson, Oldham and Adams Ltd* [xxxiii] where a company dealing in wines and spirits had been the subject of a successful takeover bid by John Holt & Co. (Liverpool Ltd). The offer made by the H of 6s per 2s ordinary share had been accepted by 99.9% of the shareholders and notice had been given of H's intention to acquire the remaining shares compulsorily at the same price (under CA 1948 s 209). The applicants, who had paid between 6s 7d and 6s 9d per share for their holdings, objected on the ground that the price offered was unfair to them. However, the court declined to intervene and it was established that the onus is on the minority shareholder to prove that the offer was unfair. Even though, *Re Bugle* established that the compulsory purchase provision is restricted to takeovers, it shows that fairness in takeovers is more about economics than law as 'the law's intervention is only an economical dimension applied to maintain commercial usage'.[xxxiv] Lastly, it can be argued that the fairness of the price paid during the compulsory purchase in takeovers is determined through 'mechanism of legal presumptions.' [xxxv] It is a plausible assumption to make that acceptance of an offer price by the majority is evidence that the price was fair. This is seen in *Re Press Caps*,[xxxvi] 'where the statutory majority have accepted the offer, the onus must rest on an applicant to satisfy the court that price offered in unfair.' Therefore, the highest price paid to majority shareholders is presumed to be a fair price, which is also the price paid for the squeeze-out purchase. The idea that the squeeze-out price is based on the price accepted by the majority rather than the pre-bid market price[xxxvii] shows, to an extent, the 'acceptance of the right of the majority to expropriate the minority.'[xxxviii]

Shareholder Equality, Information Disclosure and Director's Duties

As seen earlier, the City Code contains the rules on equal treatment of all shareholders during the takeover period. The underlying objective of these rules is to prevent the transfer of effective control through selective acquisitions at inflated prices without offering the same terms to all shareholders.[xxxix] The main principle behind the "equal treatment rule" lies in the fact that company law should be mainly enabling or facilitative, this does not mean elimination of "legal intervention" - which includes the avoidance of substantial market failure by providing mandatory provisions to protect shareholders.[xl] The Companies Act of 2006, specifically s 943, reflects this and enables the Takeover Panel to create and establish rules including regulations regarding equal treatment of shareholders (as seen in the City Code).

In the UK, it has been established[xli] by the courts that the directors who manage a company are only answerable to the company and generally, do not owe any contractual or fiduciary duty to the shareholders. Directors owe fiduciary duties to the company and cannot use their powers to further their personal interests. However, in certain circumstances, as seen in *Heron International Ltd v Lord Garde*[xlii], directors sometimes owe a fiduciary duty towards the company's members (as distinct from the company). It is also important to note that the ruling in *Heron* cannot be taken to be of general application as it relied upon the special article which gave the board control over the transfer of the voting shares.

The courts have also established that the directors must not exercise their powers in such a way as to prevent members from obtaining the best price for their shares although they are not under a positive duty to recommend and facilitate implementation of the highest offer. This is seen in the case of *Re a Company (No 008699 of 1985)* where rival takeover bids had been made for the shares in a private company, one by a company controlled by the target company's own directors (referred to a 'N' bid) and another, higher bid by a trade competitor. The chairman had sent a circular to all the members urging them to accept the N bid and explained with reasons why the higher bid could not succeed. During the proceedings, it was claimed that the directors had been in breach of duty in not recommending the higher offer and not taking the steps required to facilitate the chances of that offer being successful. The court held that 'the directors of the company were not under a positive duty to recommend and facilitate the implementation of the higher offer. If, however, the directors of a private company chose to advise shareholders on competing offers , fairness required that such advice should be factually accurate and given with a view to enabling shareholders to sell at the best price.'[xliii] Furthermore, in *Fiske Nominees Ltd v Dwya Diamond Ltd*[xliv], the court mentions another special circumstance where in sufficient information has to be given to the members to enable them to evaluate the offer properly. It was also recently held that 'in order for it to be fair, an offer must be made in sufficient detail to enable an informed decision to be made.'[xlv]

From a securities law perspective, there is a market argument that it is wasteful to legislate on takeover activities if only to achieve equal treatment of shareholders.[xlvi] The authors of this theory argue that share-holders need not be treated equally in particular takeover transaction, because by diversifying their investment portfolios, investors may protect against the risk of consistently falling on the losing side of unequal treatment.[xlvii] Furthermore, the market can even out apparent inequality in this way, the costs of unneeded rules to promote equality might well be though socially wasteful.[xlviii] Critics have argued that ultimately a legal company-law style response via the TOD affirming the long-standing principle of the City Code should be seen as the most appropriate protection of minority shareholders' interests.

The Takeover Directive and Minority Shareholder Protection

An interesting argument made by commentators is that the UK takeover system and regulations offer superior protection to minority shareholders than provided at the EU level. They argue that the primary objective of the Takeover directive is to strike a balance between fulfilling the objective of executing the corporate restructuring objectives through takeover activities and the requirement of safeguarding the interests of minority shareholders, the latter being incidental to the former. It is further argued that European takeover law, which treats unfair treatment of minority shareholders as a barrier to restructuring of companies, ensures that investors are free freely able to invest their capital into shares of EU companies in order to establish themselves in another Member State.[xlix] This led to the need to introduce takeover rules which provided mechanisms such as equal treatment, mandatory bid, and squeeze-out rules. In particular, it is argued that the UK position is favourable to the offeree than the offeror when calculating the threshold in relation to a minority shareholder wishing to exercise their sell-out right. Treasury shares are only included in calculating the threshold for a sell-out right (as contrasted with calculating the threshold for a squeeze-out right).[l] This ultimately gives a higher protection to the minority shareholder to exercise their sell-out right compared to the position of the bidder to exercise their squeeze-out right.

It is noticeable that UK law has always protected the minority shareholders, this is reflected in its emphasis on requiring the alternation to be for the benefit of the company as an entity. This is seen in *Brown v British Wheel Co Ltd*, where the court refused to permit a compulsory purchase that subjectively benefited the majority rather than the company as an entity.[li] It also must be stated that this decision was not an outlier to the court's general approach (as seen in *Heron*) but it is a part of an established pattern. In the case of *Dafen Ltd v Llanelly Steel Co,* the court refused an alteration of the articles that would enable the majority to compulsorily purchase the shares of any other member.[lii] Additionally, in *Dafen*[liii], the court held that the majority were confusing their own interests with the benefit of the company as a whole. Lastly, in *Sidebottom v Leese Ltd*[liv], the court only allowed an alteration of the articles which would include a provision for the majority to compulsorily purchase the minority shares, when it was found that the alteration was bona fide and was for the benefit of the company as a whole.

Comparing the outcome of these cases with the provisions in the Takeover Directive at the EU level (Part 28 of the Companies Act 2006) may result in contradicting results as the EU regulations seem to allow 'expropriation of minority shareholders without requirement of bona fides'[lv] which is required in the UK cases.

SCOPE FOR REFORM OF TAKEOVER REGULATION POST CADBURY PLC'S TAKEOVER

On 19th January 2010, the board of Cadbury Plc (Cadbury) announced that it had finally agreed to Kraft Foods Inc.'s (Kraft) final offer of £11.9 billion to acquire Cadbury PLC and would recommend to shareholders a revised takeover offer.[lvi] However, this development was not greeted with unanimous approval. Some Cadbury shareholders strongly felt that the offer undervalued the company and on the other hand, certain Kraft shareholders felt that it overvalued it. Apart from shareholders, unions were also concerned due to the potentially incoming job losses. Furthermore, the media started referring to the outcome of the takeover deal as the loss of an "iconic" British manufacturer to a "foreign conglomerate"[lvii] and there concerns that Kraft would change Cadbury's business practices and effectively undermine the "Cadbury commitment" to corporate social responsibility. Cadbury (founded in 1824) was a long-established UK company and has 'been regarded with special affection in the UK'[lviii] due to a number of reasons such as its possible longevity, its origins as a partly philanthropic concern that was launched by the Cadbury family. The successful takeover by Kraft led to much public and political distress. Furthermore, the workforce of Cadbury were substantially unhappy as they anticipated that the UK factories would shut down leading to a loss of jobs for the workforce; Kraft made assurances during its bids of intention to keep the Somerdale factory open but a week after the offer was accepted by Cadbury's shareholders, Kraft announced the closure of this particular factory.

The combination of the public and political distress led to calls for changes in the manner in which takeovers were regulated in the UK. One particular concern was that it had become too easy for hostile bidders to succeed and that takeover contests were being determined largely by investors who possessed no interest in the long-term well-being of the company.[lix] To address the concerns, the Takeover Panel (The Panel) responded in June 2010 by commencing a review of certain aspects of takeover regulations and publishing a Consultation Paper.[lx] However, this paper did not propose specific amendments to the existing Takeover Code but rather set out both sides of the argument for change on the basis of its own experience and issues raised when discussed with certain interested parties. Some of these changes are discussed below.

Increased protection for offerees against "virtual bids"

The Takeover Panel accepted that the conduct of an offeree's business and its board's negotiating power could be detrimentally affected by the lengthy "virtual bid period".[lxi] This may have been accepted because in recent years, the period prior to the announcement of a firm offer had become significantly more important as the first announcement of the potential offer often contains a significant amount of information and is meant to "test the waters" without the obligation of making a formal offer of incurring the costs of making an offer.[lxii] The Panel further accepted that there seems to be an increasing trend for potential offerors to announce a possible offer without further commitment and therefore, it proposed to amend the Code to require that the potential offeror be named in the announcement of a potential offer and it must within four weeks: announce a firm intention to make an offer; apply jointly with the offeree for an extension; or announce that it will not make an offer. This approach adopted by the Panel will bring greater certainty and clarity in regards to the duration of the entire process and might act as an incentive for the potential offeror to avoid its interest becoming public until the offeror is prepared to make a bid. This provision will have the effect of creating an automatic "put up or shut up" deadline and the burden of proof will shift to the parties to explain why the deadline should be extended. A common concern regarding this provision is that the potential offeror might be rushed into making a hasty or uninformed decision.

Increased transparency and better quality of disclosure

In the Cadbury case, it was estimated that the advisory fees reached approximately $100 million though this information was not disclosed, the Panel considered whether there should be an improvement in the quality of disclosure of offer-related fees. Even though there were strong arguments from both sides[lxiii], the Panel concluded, that fees should be disclosed. It proposed to amend the Code to require disclosure of: the estimated aggregate fees payable by the offeror and offeree in the offer document and response circular; the estimated advisers' fees of each category of adviser to each of the parties; financing fees; and promptly, any material changes to the estimated advisers.[lxiv] This approach is well formulated by the Panel as it ensures that disclosure of this information cannot be used to manipulate the bid as the information is to be disclosed in a way which does not reveal sensitive, commercial information regarding the offer.

Another type of disclosure which was considered by the Panel involved the disclosure of financial information in relation to an offeror and the financing of an offer. Generally, this type of disclosure was only necessary in the context of a securities exchange offer, the Panel accepted that other stakeholders may have an interest in this information and as a result, recommended disclosure of detailed financial information on the offeror and details of the debt facilities or other instruments entered into by the offeror in order to finance the offer.[lxv]

Extensive recognition of the interests of the offerees' shareholders

In the aftermath of the Cadbury case, the respondents of the Panel's consultation found fault with the failure of the offeror and offeree to disclose anything but minimum information. Rules 24.1 and 25.1 of the Code state that an offeror is to include in the offer document its intentions in relation to the offeree, the offeror itself and the employees of both, and the offeree to state its view on these plans. The Panel decided that the offeror should be required to make disclosure as per r. 24.1, but also to make a negative statement if there are no such plans. Additionally, the Code will clarify that the statements in the offeror's documents relating to the offeror's intentions of in relation to the offeree and its employees shall be expected to hold true for a period of at least one year following the offer becoming or being declared wholly unconditional. This new provision might be highly beneficial in future takeover deals as it will prevent scenarios such as the shutting down of the Somerdale plant (as seen above) by Kraft from occurring.

Along with the previously discussed proposal, the Panel put forward another proposal in this area. This proposal relates to requiring offeree boards to inform employee representatives of their existing rights under the Code to the response circular their opinion of the effects of the offer on employment.[lxvi] This is a huge step and will promote greater participation as it might encourage more opinions. Furthermore, the Panel also proposed that the offeree underwrite the costs of the employee representatives obtaining such advise as is reasonably necessary to verify the information submitted. [lxvii]

CONCLUSION

The shareholder-centric nature of takeover regulation in the UK has been central since its creation. As argued in this article, the UK takeover system is superior in terms of protection to minority shareholders and equality amongst shareholders in general. Furthermore, the UK position is compared to the EU level, where it is found that the ultimate task of the Takeover Directive is to strike a balance between the corporate restricting objective and the need for protecting the interests of minority shareholders even though the latter being incidental to the former.[lxviii]

The safeguards which enable shareholder equality and minority protection are discussed in detail and it was noted that the mandatory bid rule may be the subject of heavy criticism but it is difficult to see a better strategy than the mandatory bid rule, as if left to market forces minority shareholders might not be able to sell their shares at a fair price. Most importantly, even after accounting for all its flaws, the mandatory bid rule provides an exit strategy at a fair price. The City Code and the numerous safeguards (Squeeze-out/Sell-out rights, mandatory bid rule and information disclosure), are all part of the protection provided under takeover regulation and are ultimately the law's response to ensure that a fair price is paid to the shareholder.

The latter part of the article deals with proposals for reform put forward by the Panel in the aftermath of the Cadbury case. The Panel may have put forward some questionable proposals but as argued in this article, the response to the calls for change were executed in a fair and balanced manner. Furthermore, the Panel has indicated its intentions to look further at broader issues relating to economic cases and the corporate law framework, for takeovers. The Cadbury takeover has been one of the most influential cases in bringing about amendments to the Code via the Pane's proposals although its final legacy may have substantial contributions to company law in general.

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