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TAKEOVERS PANEL

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Rule 20 of the Code and collateral arrangements in a takeover

Background

A key feature of the Code is that a takeover offer must be made on the same terms and provide the same consideration for all securities belonging to the same class of equity securities under offer. This is set out in rule 20.

It is not unusual for an offeror, or an associate of an offeror, to enter into agreements or arrangements ("collateral arrangements") with one or more target company equity security holders outside the formal offering documentation. A common example is the *"lock-in"* or *"pre-bid"* agreement, pursuant to which a target company shareholder agrees to accept a proposed offer with special terms.

The Code does not prohibit collateral arrangements per se. There may be legitimate commercial justifications for collateral arrangements. However, if the effect of the collateral arrangements is to provide terms or consideration to a target company shareholder under a takeover offer, which differ from those offered to other shareholders, those arrangements will breach rule 20.

The purpose of this note is to provide some guidance as to when collateral arrangements may have the effect of providing to some target company shareholders additional or different terms or consideration in breach of rule 20.

The Panel applies the following principles when considering whether a collateral arrangement may raise issues of compliance with rule 20:

(a) Rule 20 requires that the offer must be the same to all the shareholders within the same class. Compliance is not achieved if the terms of an offer, as between shareholders of the same class, are different. Even if the differences are (or may be) compensated for on an analysis of the value of those differences, rule 20 will not have been complied with because the offer must be on the same terms to all shareholders in the class. Accordingly, the question is whether a collateral arrangement is *part* of the takeover offer.

(b) Determining whether the collateral arrangement is part of the takeover offer involves the Panel making an inquiry into the substance of the collateral arrangement. It is common for an offeror to enter into arrangements with parties, who are also target company shareholders, for reasons to do with the future of the target entity once acquired. These could include, for example, assistance with transition, knowhow transfer, incentivisation, etc.

(c) Compliance with rule 20 is a substance over form test. Collateral arrangements may channel takeover consideration to a shareholder by means of a separate contract where there is no real rationale for the separate contract. In cases of fraud, lack of good faith, unreasonableness and so forth the Panel may go behind the collateral arrangement to see whether, in reality, it is part of the offer and therefore in breach of rule 20.

(d) If the Panel considers there to be any appreciable possibility that a collateral arrangement could be other than what it purports to be, and may involve non-compliance with rule 20 of the Code, the Panel may convene a meeting under section 32 of the Takeovers Act 1993 to consider whether to exercise its enforcement powers.

To help illustrate the issues, some cases that have been considered by the Panel are set out below.

Lowe Corporation Limited / Blue Sky Meats (N.Z.) Limited

In late 2002, Lowe Corporation Limited ("Lowe") made a takeover offer for Blue Sky Meats (N.Z.) Limited ("Blue Sky"). Horizon Meats New Zealand Limited ("Horizon") was a 37% shareholder in Blue Sky and held an exclusive marketing contract with the company.

Lowe and Horizon entered into a pre-bid agreement under which Horizon agreed to accept Lowe's takeover offer and Lowe agreed to get Blue Sky to cancel an exclusive marketing contract, for a payment of $2.7 million to Horizon, if Lowe's offer succeeded.

The independent adviser appointed to opine on the merits of the takeover ("the rule 21 adviser") opined in its report that if the $2.7 million overcompensated Horizon for cancellation of the marketing contract, Horizon could be receiving additional consideration under the offer. However, the adviser stated in its report that it did not have sufficient information to verify whether the $2.7 million represented fair value for cancellation of the contract. The directors of Blue Sky, who opposed the takeover, said in the target company statement that one shareholder may be receiving additional consideration for its shares, which was different from other shareholders. This was tantamount to their saying that the offer breached rule 20 of the Code.

The Panel was therefore concerned that Lowe's offer may have breached rule 20 and decided to hold a meeting under section 32 of the Takeovers Act to determine the matter. The Panel retained its own independent expert to assist in its deliberations.

The expert opined that the $2.7 million would represent fair value for the cancellation of the marketing contract. Accordingly, the Panel was satisfied that there was no breach of rule 20 in that case.

Aged Care Services New Zealand Holdings Limited / Guardian Healthcare Services Limited

In late 2004, Aged Care Services New Zealand Holdings Limited ("Aged Care"), the acquisition vehicle of Pacific Equity Partners, successfully completed a takeover for 100% of Guardian Healthcare Services Limited ("Guardian") for $176.2 million.

Prior to the offer, Aged Care had entered into lock-ins for about 40% of the voting securities of Guardian. Some of those lock-ins were with senior executives in Guardian who were also shareholders. Those arrangements provided for equity in Aged Care to be issued to those senior executives as a performance incentive.

These arrangements raised questions under rule 20 because the executives were also shareholders in Guardian. The rule 21 adviser opined that there were no rule 20 issues arising. The Panel decided not to take the matter any further.

Bacardi New Zealand Holdings Limited / 42 Below Limited

In late 2006, Bacardi New Zealand Holdings Limited ("Bacardi") made a takeover offer for 42Below Limited ("42Below"). Panache International LLC ("Panache") was an option holder in 42Below and also held a distribution contract with the company. The two owners of Panache also held options and shares in 42Below.

It was agreed between 42Below and Panache during the course of the takeover that, after successful completion of Bacardi's offer, the distribution agreement would be terminated (with payment of a termination fee).

To address concerns about the compliance of the termination fee with rule 20, the 42Below directors asked the rule 21 adviser to opine on the issue in its report. The rule 21 adviser opined that the termination fee fell within its assessed value range for the distribution agreement.

The Panel noted that the opinion of the rule 21 adviser did not necessarily mean that Bacardi's offer complied with rule 20 of the Code. However, the Panel considered that in light of the rule 21 adviser's opinion it would not take any further action unless it received a complaint or unless further information came to light that challenged the rule 21 adviser's opinion.

In addition to the Panache issue, another company, 420 Spring Water Limited ("420 Spring Water"), also was involved in a collateral arrangement. The majority of shares in 420 Spring Water were owned by 42Below. 42Below entered into an agreement with the other shareholders in 420 Spring Water under which 42Below was granted an option to purchase the shares in 420 Spring Water that it did not already own. The outstanding shares in 420 Spring Water were owned by persons who also owned shares in 42Below. The option agreement was conditional on Bacardi's takeover offer for 42Below becoming unconditional. The purchase price under the option agreement raised concerns under rule 20. The Panel asked the rule 21 adviser to opine on the issue. The rule 21 adviser report stated that the option was negotiated on an arms-length basis and that the adviser was satisfied that it did not confer any additional consideration to the minority shareholders in 420 Spring Water in respect of the Bacardi takeover offer.

HT Media Limited / Canwest MediaWorks (NZ) Limited

In mid-2007 HT Media Limited ("HT Media") made a takeover offer for Canwest MediaWorks (NZ) Limited ("MediaWorks").

MediaWorks' directors and senior officers held shares or options in MediaWorks. Some of those directors and senior officers entered into arrangements with HT Media's parent company, HT Media Holdings Limited ("HT Holdings"), under which they agreed to accept HT Media's offer and invest in the equity of HT Holdings following successful completion of the offer. HT Holdings agreed to fund part of that investment through loans to trusts associated with those directors and senior officers, repayable on the sale of the equity investment.

The Panel was concerned that these arrangements may not comply with rule 20 and asked the rule 21 adviser to opine on the issue in its report. The rule 21 adviser opined that such arrangements were common in private equity transactions such as HT Media's takeover offer, as a method of incentivising management and did not in this case represent additional consideration being offered to those directors and senior executives. The matter was not taken any further.

Simplot Mr Chips Limited / Mr Chips Holdings Limited

In mid-2008 Simplot Mr Chips Limited ("Simplot") made a takeover offer for Mr Chips Holdings Limited ("Mr Chips").

Certain shareholders ("the locked-in shareholders") representing almost 82% of Mr Chips had entered into arrangements with Simplot and its parent company Simplot Australia Pty Limited ("SAPL") under which they agreed to accept Simplot's offer and, following successful completion of the offer, subscribe for equity in Simplot. Those shareholders were directors and senior officers of, or major suppliers to, Mr Chips.

Another shareholder complained that those arrangements breached rule 20 because they gave the locked-in shareholders an opportunity to reinvest in the Mr Chips business; an opportunity which was not available to other shareholders.

Mr Chips also entered into "service agreements" with two companies that were associated with the Chairman and the CEO of the company. Both of the Chairman and CEO had entered into lock-in agreements with Simplot. Under the service agreements, Mr Chips would pay fees for the work undertaken by the Chairman and CEO in negotiating the takeover terms with Simplot. The fees were linked to the eventual offer price and were payable on the offer becoming unconditional. The independent adviser noted that the level of fees was high, but said that the service agreements had been disclosed to the board early in the negotiation of the takeover, and that the high price reflected Mr Chips' initially low expectations of the takeover price.

Mr Chips also paid an additional "loyalty incentive payment" to the CEO, who was a locked-in shareholder. The rule 21 adviser considered that this benefit was attributable to the CEO as CEO and not as a shareholder because such payments were a common feature of takeover offers and were designed to compensate the CEO for the additional work required to keep management stable during the disruption caused by the takeover offer.

The rule 21 adviser opined that the arrangements with the locked-in shareholders did not confer any additional benefits to those parties as shareholders in Mr Chips. One factor that the adviser viewed as important in its analysis was that the locked-in shareholders would not be investing in the equity of Simplot in proportion to their shareholding levels in Mr Chips. The largest of the locked-in shareholders was in fact investing in only a very small proportion of the equity of Simplot. Accordingly, that shareholder was effectively exiting for cash on a similar basis to other Mr Chips shareholders.

The Panel met to consider the complaint and engaged external counsel. The Panel considered that the terms of the arrangements with the locked-in shareholders would be terms of the takeover offer to the extent that the benefits provided under those arrangements were at undervalue. After reviewing the relevant documentation the Panel considered that there was insufficient evidence to conclude that the arrangements with the locked-in shareholders were at undervalue and decided not to pursue the matter.

Dairy Trust Limited / Open Country Cheese Limited

Dairy Trust Limited ("Dairy Trust") held 52.4% of the shares in Open Country Cheese Limited ("OCC"), a Code company. Olam International Limited ("Olam"), held 19.9% of the shares in OCC.

Olam and Dairy Trust entered into a "subscription agreement" under which Olam would subscribe for new shares of Dairy Trust for $78.6 million. Olam would then have the right to appoint two directors to the Dairy Trust board and would also hold a first right of refusal over a percentage of Dairy Trust's production output for five years. Dairy Trust agreed to use part of the subscription price to make a takeover offer for OCC.

The subscription agreement was conditional on Olam and Dairy Trust entering into a pre-bid agreement. Olam and Dairy Trust entered into this pre-bid agreement, under which Dairy Trust agreed to make a full takeover offer for OCC and Olam agreed to accept that offer for its entire 19.9% shareholding. In accordance with this agreement Dairy Trust made a takeover offer for OCC and Olam accepted that offer.

The benefits accruing to Olam under the subscription agreement, being the right to appoint two directors to the Dairy Trust board and the first right of refusal over a percentage of Dairy Trust's production output for five years, raised questions under rule 20.

The rule 21 adviser report opined that Olam was not receiving any additional consideration for its acceptance of the offer because:

- The first right of refusal was more directly related to Olam's subscription for Dairy Trust shares. The subscription price for those shares was reasonable;
- The first right of refusal conferred advantages on both parties. Olam would be paying arms length commercial prices for product and was therefore not extracting any premium from the supply agreement;
- Supply agreements of this nature were commonplace in the industry.

On that basis, the Panel considered that there was no appreciable possibility that the benefits accruing to Olam under the subscription agreement constituted consideration for its acceptance of Dairy Trust's offer in breach of rule 20.

Conclusion

The question of whether collateral arrangements comply with rule 20 is a matter of fact in each case. Compliance with rule 20 is a substance over form test. The Panel considers that rule 20 compliance is one of the matters which goes to the "merits" of an offer. Accordingly, the Panel expects the issue to be addressed by the rule 21 adviser.

The Panel also expects target company directors to ensure that the rule 21 adviser properly addresses the issue. If the issue is not properly addressed, or doubts are raised about whether or not the arrangements comply with rule 20 of the Code, the Panel may have little choice but to hold a meeting under section 32 of the Takeovers Act to determine the matter.

Guidance note – payment of takeover consideration in foreign currency

The Takeovers Code has no prescriptive rules about the form of consideration that can be offered in a takeover. Consideration can include scrip (e.g., equity securities in the offeror, debt securities, etc), cash, any other thing of value, or a combination of these.

The terms of an offer may provide for target company shareholders to be paid the offer consideration in a currency other than New Zealand Dollars. A number of recent offers have included this facility.

The key issue for offerors to be aware of when including options for payment of any type of consideration is that any such offer must comply with rule 20 of the Code. Rule 20 provides that:

An offer must be made on the same terms and provide the same consideration for all securities belonging to the same class of equity securities under the offer.

This means that all offerees must be given the option to be paid under any of the consideration options. For example, it would likely result in a breach of rule 20 of the Code if, say, only Australian resident target company shareholders were offered the option of being paid in Australian Dollars.

Where consideration in a foreign currency is offered, the Panel's expectation is that the terms of the offer will clearly indicate how the exchange rate will be calculated at which the offer consideration is to be converted from New Zealand Dollars into foreign currency. This may include a reference to an objectively determined formula for calculating the exchange rate. For example, the formula might be the spot rate for buying the relevant foreign currency with New Zealand dollars quoted by a reputable financial institution at a specified time before the date of payment.

Prospective offerors and legal advisers are encouraged to discuss with the Panel executive any questions they may have about offering payment of foreign currency as consideration.

Where consideration in a foreign currency is offered, the Panel's expectation is that the terms of the offer will clearly indicate how the exchange rate will be calculated at which the offer consideration is to be converted from New Zealand Dollars into foreign currency.

Calculating the specified percentage for a partial takeover offer

The Panel is concerned that market participants may be encountering difficulty with the application of rule 9 of the Code.

A partial offer under the Code must be made for a "specified percentage" of target company voting securities not already held or controlled by the offeror (rule 9).

There have been quite a number of instances where the specified percentage was misstated by the offeror in its takeover documentation.

To assist market participants, the Panel has prepared the following example calculation of a specified percentage for a hypothetical partial offer, for reference:

$$\frac{\textit{Number of total voting rights sought by offeror}}{\textit{Number of total voting rights not already held or controlled by offeror}} \times 100 = \textit{The specified percentage}$$

Example: The target company has 100,000,000 voting rights on issue. The offeror already holds or controls 19,900,000 (or 19.90%) of the total voting rights. The offeror wishes to increase its total holding to 50,100,000 voting rights (or 50.10%).

To obtain its desired total holding, the offeror must acquire 30,200,000 (or 30.2%) voting rights that it does not already hold or control. The specified percentage of the partial offer will be:

$$\frac{30{,}200{,}000 \textit{ (number of total voting rights sought)}}{80{,}100{,}000 \textit{ (number of total voting rights not already held or controlled by offeror)}} \times 100 = \mathbf{37.70287\%} \textit{ (the specified percentage)}$$

Extension of offer period for a partial offer

There are potential risks associated with extending the offer period for a partial offer if the offer is likely to become unconditional before the end of the extended offer period.

A partial offer is an offer made by a bidder to all shareholders in a target company for less than 100% of those persons' voting securities. A partial offer made under the Code is subject to the same rules as those which apply to a full offer, apart from the special provisions in relation to partial offers set out in Subpart 2 of Part 3 of the Code.

A partial offer must specify the period for which it will remain open and it must remain open for that period. The offer period must commence with the date of the offer and be not shorter than 30 days and not longer than 90 days (rule 24 of the Code). The offer period may be extended by way of a variation of the offer but must not be extended beyond the maximum 90-day period (rule 24A).

A shareholder in the target company may accept a partial offer in respect of any number of their voting securities. The Code (rules 11 to 13) prescribes how the offeror is to scale acceptances to ensure that voting securities are taken up under the partial offer appropriately as between acceptors when excess acceptances have been received. Any scaling of acceptances can only occur after the close of the offer period, once all acceptances have been received.

Rule 33 of the Code provides that the offer must state a date by which the consideration for the offer must be sent to those persons whose securities are taken up under the offer. The date must be not later than seven days after the later of –

(a) the date on which the offer becomes unconditional; or

(b) the date on which an acceptance is received; or

(c) the end of the offer period as first specified in the offer document.

In the case of a partial offer, it is wise to use the full rule 33 formulation so that, even if the offer becomes unconditional during the initial offer period, consideration is not payable until seven days after the end of the offer period as first specified in the offer document.

An offeror who extends a partial offer beyond the initial closing date first specified in the offer document risks the offer becoming unconditional before the new closing date. If this occurs, the offeror may be unable to comply with the Code's requirements to pay the offer consideration because the amount of any scaling is determined by the number of acceptances received through the entire offer period, not just in the period up to when the offer became unconditional. Until scaling is completed, the offeror will not know how many securities it may take up from each offeree and, accordingly, how much consideration to pay each offeree.

The Panel advises offerors to set a realistic initial offer period, and if it is necessary to extend that period, to do so in reasonably small segments, to minimise the risk of the offer going unconditional earlier than seven days before the end of the offer period. An offeror may also consider making its intentions clear about the date by which the offer will definitely close, by way of a last and final statement. The Panel expects that last and final statements will be adhered to as to a promise (refer to *Code Word No.22* for further information). Such a last and final statement can help shareholders (who may want to delay accepting the offer until just before the offer closes) to understand that the offeror will not keep extending the offer period.

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