PARTS ONE TO FIVE OF THE TAKEOVERS CODE

A CONSULTATION PAPER ISSUED BY THE TAKEOVERS PANEL

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INTRODUCTION

1. The Takeovers Panel has the function, among other things, of keeping under review the law relating to takeovers of Code companies and recommending to the Minister of Commerce any changes to that law that the Panel considers necessary.[1]

2. The Takeovers Code came into force on 1 July 2001. The Panel has administered the Code since then and from time to time becomes aware, through its interaction with the market, of problems, which are often just minor technical drafting anomalies, which leave the Code less efficient and effective than it could be.

3. The Panel is committed to having the Code work well. To this end, the Panel is undertaking a 'low policy content' review of the Code, and is proposing a number of amendments, mostly of a technical nature. The proposals are of principal interest to practitioners actively involved in the takeovers market. The review does not extend to the fundamental policy underlying the Code.

4. In 2009, the Panel undertook public consultation on a number of proposed amendments to the Code's provisions which govern partial takeover offers. This formed the first stage of a three-stage public consultation process on technical issues with the Code.

5. This current Discussion Paper (which forms the second stage of the process) is limited to matters in Parts 1 to 5 of the Code. Part 1 of the Code relates to preliminary matters in the Code, such as definitions and anti-avoidance provisions. Part 2 contains the Code's fundamental rule and its exceptions. Part 3 prescribes the specific provisions relating to the exceptions to the fundamental rule, such as the basic requirements for a takeover offer, and for acquisitions and allotments that must be approved by the shareholders of a Code company. Part 4 sets out in detail various rules which regulate offers made under the Code. Finally, Part 5 relates to dealings in securities in a target company by an offeror during an offer period and defensive tactics by the target company.

6. The Panel expects to issue a third, and final, Discussion Paper on technical/low policy content matters in late 2010 or early 2011, which will address issues relating to Parts 6 and 7, and Schedules 1 to 3 of the Code, together with any other miscellaneous matters not covered by the earlier Discussion Papers. Once the Panel has completed this review of the Code, it expects to make recommendations to the Minister which incorporate all these proposed amendments to the Code, by the end of 2010, or in early 2011.

7. This Discussion Paper addresses the issues, that the Panel has identified, in numerical order of the relevant rules in the Code, rather than trying to rank in order of importance. Each section is followed by a brief questionnaire for consultees to consider. Consultees are also invited to make submissions on any other problems with Parts 1 to 5 of the Code that they are aware of.

Request for comments on this paper

8. The Panel invites submissions on this Discussion Paper. The closing date for submissions is **5.00 p.m. Friday, 30 July 2010**. Submissions should be sent:

- By email - takeovers.panel@takeovers.govt.nz

- By post - Takeovers Panel
  Level 3, Solnet House
  70 The Terrace
  P.O. Box 1171
  WELLINGTON; or

- By fax - +64 4 815 8459.

Official Information Act 1982

9. Any submissions received are subject to the Official Information Act 1982. The Panel may make submissions available upon request under that Act. If any submitter wishes any information in a submission to be withheld, the submission should contain an appropriate request (together with a clear identification of the relevant information and the reasons for the request). Any such request will be considered in accordance with the Official Information Act 1982.

Issues addressed in the Discussion Paper

10. The following provisions contained in Parts 1 to 5 of the Code have been identified by the Panel as containing problems that impact on parties to transactions involving changes of control of Code companies:

    (a) Rule 3(1) defines a number of terms used in the Code in a manner that creates an anomaly with respect to the application of rule 7(c) and (d) of the Code (see paragraphs **13 to 30**);

    (b) Rules 15(a) and 16(a) do not require disclosure of the identity of the person whose control is increasing in a Code company (see paragraphs **31 to 45**);

    (c) Rule 16(b) is inflexible, and is accordingly, the subject of many of the exemptions granted by the Panel (see paragraphs **46 to 62**);

    (d) Rule 25, which relates to offer conditions, is out of balance with rule 38 of the Code, which relates to defensive tactics engaged in by the target company (see paragraphs **63 to 92**);

    (e) Rule 30 contains a drafting anomaly (see paragraphs **93 to 104**);

    (f) Rule 35 prevents an offeror (or certain of the offeror's associates) from accepting its own offer, and, thereby, has been the subject of a number of exemptions (see paragraphs **105 to 113**);

11. Each of these issues, and the proposed options for resolving them, is discussed separately below.

POLICY OBJECTIVES

12. The Panel’s purpose in undertaking a review of a technical nature/low policy content of the Code is to ensure that the Code is working as effectively and efficiently as possible. The following policy objectives apply to dealing with all of the problems with the Code that are considered in this Discussion Paper:

    (a) removing inconsistencies in wording and other drafting anomalies;

    (b) reducing potential confusion for investors in target companies; and

    (c) facilitating the efficient operation of New Zealand’s capital markets.

PROBLEM IDENTIFICATION AND OPTIONS

A. Definitions in the Code

The problem

13. Rule 7 of the Code prescribes the various exceptions to the fundamental rule (contained in rule 6) by which a person may become the holder or controller of voting rights in a Code company. Rule 7(c) and (d) allow a person to increase voting control by way of an acquisition or allotment, respectively, of voting securities if the acquisition or allotment is approved by an ordinary resolution of the Code company.

14. The Panel has identified an issue with the drafting of rule 7(c) and (d) which may reduce the intended scope of these exceptions to the fundamental rule. This is most likely to be a problem where there is an acquisition or allotment of securities in a body corporate that is not a New Zealand-registered company, e.g., a unit trust or an overseas-registered company which, in turn, holds or controls 20% or more of the voting rights in a New Zealand Code company.

15. Rule 7(c) and (d) provide for increases in voting control by way of, respectively, an acquisition or an allotment of *"voting securities in a code company or in any other body corporate"* to be approved by the shareholders of the Code company.

16. A close reading of a string of relevant defined terms in the Code points out the problem. Rule 3(1) of the Code defines *"voting security"* as *"an equity security that confers a voting right"*. *"Equity security"* and *"voting right"* are defined in rule 3(1) as:

> *"**equity security** means…any interest in or right to a share in, or in the share capital of, a company (whether carrying voting rights or not…*[2]
>
> …
>
> ***voting right** means a currently exercisable right to cast a vote at meetings of shareholders of a company…"*[3] [emphasis added].

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17. *"Company"* is defined by rule 3(1) as having the same meaning as in section 2(1) of the Companies Act 1993. Section 2(1) of the Companies Act provides that *"company"* means a company registered under Part 2 of the Companies Act (i.e., a company registered in New Zealand).

18. Accordingly, *"voting securities"* for the purposes of rule 7(c) and (d) could be argued to mean voting securities that are issued only by companies registered under the Companies Act.

19. Consequently, where the acquisition or allotment that triggers the fundamental rule is of securities in an entity which is "upstream" from a Code company, and that entity is not a company registered under the Companies Act, the approval of the shareholders of the Code company affected could not, on a strict application of all the relevant defined terms included in the Code, be obtained under rule 7(c) or (d).

20. By way of example, if an entity that is not a company registered under the Companies Act (say, a company registered in Australia, the "upstream company") holds more than 20% of the voting rights in a New Zealand Code company, a change in control of the

Code company could occur if there were Code-relevant acquisitions or allotments of voting securities in the upstream company (e.g., the upstream company is owned by a single shareholder, who sells the upstream company, or a significant parcel of shares in it, to a new shareholder). Such a transaction may trigger the fundamental rule in the Code.

21. However, the voting securities in the upstream company are not *"voting securities"* as strictly defined by the Code, because the upstream company's voting securities are not issued by a company that is registered under the New Zealand Companies Act. Accordingly, by reading the words of rule 7(c) and (d) strictly as defined, it is not possible for the acquisition or allotment to be approved by the shareholders of the downstream Code company.

22. There will have been instances in the past where the approval of shareholders was sought and obtained under rule 7(c) or (d), for acquisitions or allotments in bodies corporate that are not companies registered under the Companies Act 1993 that hold or control voting rights in Code companies. Clearly, for the words in rule 7(c) and (d), *"in any other body corporate"*, to have any meaning, rule 7(c) and (d) must be intended to cover this situation. The Panel takes this to be so and enforces the Code on that basis.

23. The Panel considers that, although this drafting anomaly can be managed, through a purposive interpretation, the opportunity of the present review provides a vehicle for tidying up this very minor matter.

<u>Options</u>

24. The following options have been identified for addressing the problem.

Option 1: Maintain the status quo

25. Under this option, Panel would maintain a purposive interpretation of rule 7(c) and (d).

26. Rule 7(c) and (d) prescribe a procedure by which the shareholders of a Code company may approve of a transaction under which a person increases their voting control in the company. A drafting anomaly should not inhibit that process. The drafters of the Code clearly intended that shareholder approval under rule 7(c) and (d) ought to be available where there is an acquisition or allotment of securities carrying voting rights in a body corporate that is not a company registered under the Companies Act, as indicated by the wording of rule 7(c) and (d).

Option 2: Grant exemptions on either a case-by-case basis or a class exemption

27. Under this option, the Panel would grant exemptions, either on an individual basis or a class exemption, to address the anomaly that arises as a result of the definitions of *"equity security"* and *"voting right"*. The exemption would likely be from rule 7(c) or (d) to the extent that the voting securities must be issued by a "company", as that term is defined in section 2(1) of the Companies Act. In effect, the exemption would enable an acquisition or allotment, as the case may be, of voting securities in bodies corporate other than New Zealand-registered companies to be approved by the shareholders of a Code company in accordance with the Code.

28. An exemption, whether granted on a case-by-case basis or, alternatively, as a class exemption, would resolve the problems associated with the drafting anomaly. However, there are some disadvantages with this option:

(a) If the Panel were to grant exemptions on a case-by-case basis to resolve a drafting anomaly, this would result in additional compliance costs for market participants. It would also involve additional resources of the Panel. Together, these factors would not contribute to the efficient operation of the New Zealand capital market.

(b) It is not a particularly appropriate use of the Panel's exemption power to use it to address an anomaly in the drafting of the law. Exemptions are meant to be available in cases where the Code has unintended consequences, cannot be complied with or it does not adequately provide for unexpected or unusual circumstances.[4] The exemption option may be viable as a short-term measure, but it should not be seen as a remedy to a problem with the law itself.

Option 3: Amend the Code (preferred option)

29. Under this option, the Panel would recommend to the Minister an amendment to the Code to clearly bring bodies corporate not registered under the Companies Act into the definitions that rule 7(c) and (d) rely on. Thus, the definitions of *"equity security"* and *"voting right"* in rule 3(1) could be changed as follows:

*"…**equity security** means – (a) any interest in or right to a share in, or in the share capital of, a company, <u>or of any other body corporate</u> (whether carrying voting rights or not)…"*

*"**voting right** means a currently exercisable right to cast a vote at meetings of shareholders of a company, <u>or the security holders of any other body corporate</u>..."*

30. The proposed amendment would remove the anomaly that arises from the definitions that underpin the term *"voting securities"*, as used in rule 7(c) and (d). This would remove inconsistencies in the wording of the Code and reduce potential confusion for investors in Code companies. The Panel does not expect the proposed amendment to have any costs associated with it. It merely resolves a technical difficulty with the wording of the Code itself.

Section A - Questions to consider:

1. Do you agree that the terms *"voting security"* and "*equity security*", as they are defined in the Code, raise a problem for persons whose control percentage in a Code company increases through the acquisition or allotment of securities in bodies corporate that are not companies registered under the Companies Act?

2. Do you agree with the Panel's preferred option? If so, why? If not, why not? What would you suggest as an alternative?

3. What are your views on the Panel's other options? Would any of these be more effective at addressing the problem?

4. Do you have any other comments you would like to contribute?

B. Identity of upstream acquirer or allottee of voting securities

The problem

31. Rule 7(c) of the Code provides an exception to the prohibition in the fundamental rule, enabling persons to become the holder or controller of an increased percentage of voting rights in a Code company by way of an acquisition that has been approved by an ordinary resolution of the company. Rule 7(d) provides a corresponding exception in cases of allotments of new shares.

32. Rule 15 of the Code prescribes the information which must accompany the notice of meeting sent to the shareholders of the Code company, together with the proposed resolution for the purposes of rule 7(c). Rule 15(a) provides that this information must include "*the identity of the persons acquiring and disposing of the voting securities*".

33. Rule 16 prescribes the information required for the purposes of shareholder approval under rule 7(d) in respect of an allotment of new voting securities. Rule 16(a) provides that this information must include "*the identity of the allottee*".

34. It is a common arrangement in New Zealand for voting securities in a Code company to be held by a custodian or nominee, with the control of those securities resting with the beneficial owner. It is arguable that a notice of meeting would comply with rule 15(a), in respect of an acquisition of securities, and rule 16(a), in respect of an allotment, if only the identity of the custodian or nominee (the holder) was disclosed in the notice of meeting. In other words, the identity of the controller of the voting securities would not need to be disclosed.

35. In contrast, the identity of a person whose voting control is increasing in a Code company by means of a buyback must be disclosed in the notice of meeting sent to the shareholders for approving the transaction. This is required by clause 4 of the *Takeovers Code (Class Exemptions) Notice (No. 2) 2001* (the "class exemptions notice"). "*Voting control*" is defined in the class exemptions notice as:

> *"…a reference to a person increasing voting control is a reference to the person becoming the holder or controller of an increased percentage of voting rights in a code company."* [emphasis added]

36. Accordingly, if a custodian/nominee arrangement was being used the notice of meeting for a buyback would have to disclose the identity of the custodian or nominee (the holder of the voting securities) and the beneficial owner (the controller) of those voting securities.

37. However, aside from this inconsistency between the class exemptions notice and rule 7(c) and (d), the more important point is that the drafting of rules 15(a) and 16(a) may lead to investors being uninformed about the identity of a person who controls a significant (more than 20%) amount of voting rights in a Code company. Although there is less risk of this with respect to listed companies (the substantial security holder disclosure regime provides for the identification of the beneficial owners of securities in substantial security holder notices), the identity of the beneficial owner (and controller) will generally otherwise not be available from public sources of information (such as the Companies Register or annual reports).

38. It is worth noting, however, that persons who are involved in transactions regulated by the Code must not engage in conduct that is misleading or deceptive, or that is likely to mislead or deceive.[5] It is possible, if a Code company failed to identify the controller of the voting rights to be acquired or allotted (and relied on a strict interpretation of the rules to justify this), that the Panel could compel disclosure of the controller's identity in terms of rule 64 of the Code. This would, however, be an enforcement matter under section 32 of the Takeovers Act, which is both demanding on the Panel's and the parties' resources and can potentially have a detrimental effect on the reputation of the persons subject to the enforcement.

39. Rules 15 and 16 of the Code do not expressly stipulate the obligation of the Code company to ensure that the notice of meeting contains the information required under those rules. However, company law mandates this obligation, and the Panel enforces the Code on this basis. With the opportunity of the present review of the Code, this minor issue can be resolved.

Options

40. The following options for addressing the problem have been identified.

Option 1: Maintain the Status quo

41. Maintaining the status quo does not clearly resolve the possibility that a person whose voting securities in a Code company are held by a custodian or nominee does not need to have their identity disclosed (as a controller of voting rights) in a notice of meeting. Although the Panel could potentially address such conduct in an enforcement action under rule 64 of the Code, the Panel considers that a notice of meeting for the purposes of transactions caught by rule 7(c) and (d) of the Code ought to disclose the identity of persons who control voting rights in the Code company. Enforcement action is the 'ambulance of the bottom of the cliff'. Proper disclosure pre-empts any potential confusion for shareholders in deciding whether to approve the transaction, and for market participants observing the potential change in control.

42. Accordingly, the Panel believes that it would be inappropriate to maintain the status quo.

Option 2: Amend the Code (preferred option)

43. Under this option, the Panel would recommend an amendment to rule 15 and rule 16 of the Code to ensure that:

    (a) the identity of every person whose voting control increases as a result of the proposed acquisition or allotment, as the case may be, is stated in the information accompanying the notice of meeting; and

    (b) the Code company explicitly has the obligation of including all of the information required by rule 15 or rule 16, as the case may be, in or with the notice of meeting.

44. The proposed amendments would ensure that the controllers of voting rights are always disclosed in the notice of meeting for the purposes of rule 7(c) and (d) of the Code, and that the Code company's obligations are clear. This would reduce the potential for any confusion for market participants by ensuring that all persons who are increasing their voting control in a Code company are identified in the relevant information provided to shareholders who are voting on the change of control of their company.

45. Clarifying the obligations in rule 15 and rule 16 would also provide certainty for users of the Code regarding their responsibilities. If potential acquirers, allottees, and the Code companies responsible for preparing the notices of meeting have well-defined obligations, the likelihood of Panel enforcement action is also reduced.

Section B – Questions to consider:

1. Do you agree that there is a problem with rules 15(a) and 16(a) with respect to the disclosure of the identity of the person whose voting control in a Code company is increasing as a result of an acquisition or allotment, as the case may be?

2. Do you support the Panel's preferred option? If so, why? If not, why not?

3. Do you have any other comments you would like to contribute?

C. Inflexibility of notice of meeting requirements for allotments of voting securities

The problem

46. As noted above, rule 7(d) of the Code provides an exception to the fundamental rule, enabling a person to increase their voting control in a Code company provided that they comply with the shareholder approval requirements of the Code.

47. Rule 16(b) provides that particulars of the voting securities to be allotted must be included with the notice of meeting which contains a proposed resolution for the purposes of rule 7(d). The particulars must include:

> *"(i) the number [of voting securities] being allotted; and*
>
> *(ii) the percentage of the aggregate of all existing voting securities and all voting securities being allotted that that number represents; and*
>
> *(iii) the percentage of all voting securities that will be held or controlled by the person to whom the voting securities are being allotted after completion of the allotment; and*
>
> *(iv) the aggregate of the percentages of all voting securities that will be held or controlled by the person to whom the voting securities are being allotted and by that person's associates after completion of the allotment."*

48. The characteristics of some transactions which are subject to rule 7(d) of the Code mean that it is impossible for the Code company to specify the exact numbers and percentages required to be disclosed under rule 16(b). The information may be dependent on a number of factors outside of the company's control. Accordingly, in the absence of an exemption from rules 16(b) and 7(d) (to the extent that rule 7(d) requires compliance with rule 16(b)), the allottee and the Code company will be unable to comply with the Code.

49. Examples of the circumstances that can result in this uncertainty include:

    (a) underwriters of share issues may not know how many shares they will subscribe for under the allotment, as it is dependent upon whether, and to what degree, others subscribe;[6]

    (b) subscribers to rights to acquire shares under a rights issue may not know what percentage of voting rights in the Code company they will hold as a result of the allotment, as it is dependent upon whether, and to what degree, others subscribe;

    (c) persons exercising rights to convert convertible securities into voting securities may not know the total voting rights that will be on issue at the time of their conversion and allotment, because there will be a, possibly unknown, number of other holders of the convertible securities who may or may not also exercise their conversion rights.

50. The Panel is about to grant a class exemption which covers the situations for allotments under the classes of transactions set out in the previous paragraph.[7] The class exemption is subject to conditions which effectively modify the disclosure requirements in rule 16(b) so that, rather than expressing the exact numbers and/or percentages that may

be held or controlled by the allottee, the notice of meeting must state the *potential maximum* numbers and/or percentages. The basis for the exemption is that if the non-associated shareholders approve the potential maximum allotment of voting securities, then, by implication, the shareholders also approve any lesser percentage of voting securities that may be acquired as a result of the transaction.

51. The class exemption is subject to further conditions which ensure that the shareholders of the Code company have the necessary information to make a fully informed decision when deciding whether to approve any increases in voting control, for example, the transaction needs to be fully described, and the assumptions on which the calculations of potential maximum numbers / percentages are based also need to be set out with the notice of meeting information. For allotments that will occur over a period of more than 12 months, on-going disclosures, about the control position of the exempted allottee, must be made in the company's annual report and on its website (if it operates a website).

52. The class exemption was granted to reduce the need for individual exemptions from the Code, thus reducing the compliance costs for market participants and improving the efficiency of the Code.

53. The Panel expects the class exemption to be utilised at least several times per year. The classes of transactions to which it relates are relatively commonplace. Prior to granting the class exemption, the Panel had granted about 40 individual exemptions in respect of transactions many of which would now be covered by the class exemption.

54. However, there will be gaps in the situations covered by the class exemption. This means the Panel will still be asked to grant individual exemptions for those transactions that do not fall under the class exemption. There are, therefore, still inefficiencies in the rules.

55. When the Panel consulted with the public on the class exemption, submitters expressed a concern that the exemption could not be granted to deal with every situation where exact numbers and percentages could not be stated in the notice of meeting information. However, the Panel is not empowered to grant an exemption for every transaction, as that is not a "class". The Panel may only grant individual exemptions or class exemptions. All submitters acknowledged that a class exemption would be useful as an interim measure, but that the Code should be amended to conclusively resolve the problem.

<u>Options</u>

56. The following options have been identified for addressing the problem.

Option 1: Maintain the status quo

57. Under this option, the Panel would keep the class exemption in place. Any transactions which do not fall into the classes of transactions covered by the class exemption, but which could not comply with rule 16(b), would be considered by the Panel on a case-by-case basis for granting an individual exemption. Alternatively, applicants may ask the Panel to increase the classes to which the class exemption applies.

58. As noted above, the drawback to the class exemption is that it applies to limited classes of transactions. This means that circumstances will arise where a person does not fall under the class exemption and will require an individual exemption for a transaction to proceed. Accordingly, although the class exemption will reduce the number of applications to the Panel for individual exemptions from rule 16(b), the objective of efficiency in the operation of the Code has only partially been met.

Option 2: Amend the Code (preferred option)

59. Under this option, the Panel would recommend that the Code be amended to effectively incorporate the provisions of the class exemption into the Code itself, but without limiting the maxima disclosure regime to only certain types of transactions. Thus, the maxima disclosure regime would be available for any transaction involving an allotment of voting securities.

60. The Panel expects that the proposed amendment would have the following key features:

    (a) The detailed disclosures would likely be incorporated into a new schedule to the Code; and

    (b) A provision would be inserted into the Code that provides a requirement to the effect that if rule 16(b) cannot be complied with, then the notice of meeting must contain or be accompanied by the information required by the new Schedule.

61. The new schedule to the Code would set out all of the disclosure requirements currently contained in the class exemption (i.e., description of the transaction, potential maximum numbers and / or percentages, on-going disclosures in annual reports and on the website, etc).

62. Although the class exemption covers many of the cases where individual exemptions have been sought from the Panel in the past, its limitation to classes of transactions means that optimal efficiency has not been achieved. The proposed amendment to the Code would have general effect. This is its major advantage over the status quo.

Section C – Questions to consider:

1. Do you agree that rule 16(b) of the Code is inflexible? If so, do you think that the class exemption goes far enough to address the problems that arise from that inflexibility?

2. Do you support the Panel’s preferred option? If so, why? If not, why not?

3. Do you have any other comments you would like to contribute?

D. Invocation of defeating conditions in an offer

<u>The problem</u>

63. The Code regulates the kind of conditions that an offeror may include in a takeover offer. In this regard, rule 25(1) of the Code provides that:

"An offer may be subject to any conditions, except those that depend on the judgement of the offeror or any associate of the offeror, or the fulfilment of which is in the power, or under the control, of the offeror or any associate of the offeror."

64. An offeror has a broad discretion to include any conditions it wishes in its offer, but this is subject to the proviso that the conditions do not depend on the judgement, and are not within the power, of the offeror, or the offeror's associates. Accordingly, provided the conditions comply with rule 25(1), an offeror may specify any circumstance (except as prohibited by the proviso in rule 25(1)) which must or must not occur for the offeror to carry its offer through to completion. This flexibility is particularly important to offerors in light of rule 26 of the Code, which provides that, once it has commenced, a takeover offer may only be withdrawn by the offeror with the consent of the Panel.

65. The purpose of rule 25(1) is to prevent an offeror from circumventing rule 26(1) of the Code by setting "defeating" conditions that effectively give the offeror an option over whether to proceed to the conclusion of its offer, once the offer has been made. The Code thereby ensures that there is certainty for a target company and for the offerees that the offeror, once it makes its takeover offer, must proceed with it, except in the limited and defined circumstances of rule 26 of the Code.

66. Accordingly, provided that the offeror complies with rule 25(1), it may state conditions to its offer which are for its benefit. The offeror may express its conditions as being waivable, in its discretion. If a condition precedent is not satisfied or if a defeating condition is triggered, the offeror may elect to proceed with the offer by waiving the condition.

67. Rule 38(1) of the Code prohibits the directors of a target company, once the company has received a takeover notice or has reason to believe that a bona fide offer is imminent, from taking or permitting any action, in relation to the affairs of the company, that could effectively result in: (a) a takeover offer being frustrated; or (b) the shareholders in the target company being denied an opportunity to decide on the merits of a takeover offer.

68. Rule 39 of the Code prescribes provisos to the prohibition in rule 38(1). The rule states that what would otherwise be prohibited is allowed if one of the provisos set out in rule 39 applies. The provisos are:

    (a) the shareholders of the target company approve of the action by passing an ordinary resolution; or

    (b) the action is taken as a result of a contractual obligation, or the implementation of proposals, and that obligation was entered into, or the proposals were approved by the directors, prior to the issuing of a takeover notice by the offeror or to the target company becoming aware that a takeover offer was imminent; or

(c) if neither of the above provisos applies, the action is permitted if it is taken for reasons unrelated to the offer, but with the prior approval of the Panel.

69. The purpose of rule 38(1) is to prevent the directors of a target company from taking steps to improperly resist a takeover offer for the company. The rule captures conduct that *could effectively* defeat a takeover offer. This is a broad expression and focuses on the potential outcome of the action taken by the directors of the target company, regardless of their intentions. Moreover, the conduct does not need to *actually* lead to the offer failing or not proceeding. Accordingly, although rule 38 is primarily aimed at facilitating hostile takeovers, it can also catch conduct that is not intended by the directors of the target company to be defensive. Yet, as the rules are currently drafted, the directors of the target company must either seek relief under one of the provisos in rule 39, when, in principle, they should not have to, or risk breaching the Code.

70. The breadth of the offeror's discretion under rule 25(1) makes it possible for an offeror to specify conditions that can restrict the business activities of the target company during the period from when it makes it known to the target company that it intends to make a takeover offer and right though the offer period itself. This takeover process may run for a considerable length of time, potentially as long as six months. If the offer contains restrictive conditions, the business of the target company may be constained for a significant period.

71. The Panel commented on "restrictive" conditions in *Code Word No. 16* (May 2006).[8] The Panel considered that it was possible for a condition to be so restrictive that it prevented the target company from carrying out activities that are part of its ordinary business. In the Panel's view, it would be almost inevitable that a target company would trigger a condition such as this, meaning that the condition was effectively within the judgement or control of the offeror. This is not permitted by rule 25(1) of the Code. The article in *Code Word* has, at least, brought about the inclusion of "except in the ordinary course of business" provisos being included in restrictive conditions.

72. There may be circumstances where a defeating condition in an offer is triggered by an event which, although it may be outside the ordinary course of the target company's business, could not be described as being of material significance to the offeror in the context of the offer. Regardless of the materiality, currently the offeror may invoke its condition and allow its offer to lapse, thereby ending the takeover.

73. This broad flexibility for offerors under the Code could potentially be abused by offerors (for instance, by making spurious or tactical offers with no intention of proceeding to completion). Coupled with the rigidity of the prohibition against defensive tactics by a target company, the wide discretion for offerors to invoke defeating conditions puts the directors of the target company in a very difficult position during the pre-offer and the offer period, as the target company and its directors run the risk of triggering a defeating condition in the offer.

74. This tension has resulted in issues being referred to the Panel in relation to three recent hostile takeovers. Some of the complaints received by the Panel may have had a tactical element to them with one party to the takeover attempting to gain an advantage over the other through the complaint process. The Panel has to work with rules which appear to

be unbalanced in the sense that the target company is subject to considerable restrictions, in a way in which the offeror is not. This has resulted in difficult outcomes.

75. There is a mechanism under rule 39(c) of the Code whereby the target company may carry out an action that would otherwise be prohibited by rule 38(1) if the action is unrelated to the offer and the Panel gives its consent. This, however, is problematic because, in addition to the time and cost necessarily involved, there is no certainty that the Panel would approve an application. It puts the Panel in the difficult position of 'standing in the shoes' of the target company shareholders. The Panel also needs to be careful to avoid being drawn into the tactics of hostile takeovers and providing a regulatory advantage to one side.

76. The most significant problem for the shareholders of the target company is that, even if the directors are able to rely on a proviso in rule 39, the offeror may invoke a triggered defeating condition and allow the offer to lapse. The provisos in rule 39 only work to protect the directors of the target company from otherwise being in breach of rule 38 of the Code. They do not keep the takeover going.

77. In conclusion, the problems identified above with respect to defeating conditions in a takeover offer are threefold; currently,

(a) an offeror may invoke a defeating condition in relation to an event that is not material to the offeror in the context of the offer (i.e., a condition could potentially be triggered by a relatively trivial event, or by an event that has little or no impact on the value to the offeror of obtaining control of the target company);

(b) related to (a), the prohibition on defensive tactics contained in rule 38(1) of the Code is so broad that it can result in the target company and its directors breaching the Code even if they are not acting defensively; and

(c) in hostile takeovers, the Panel invariably receives complaints from either or both the offeror or the target company, and finds it very difficult to achieve appropriate enforcement outcomes.

Overseas jurisdictions

78. The table below sets out, in summary form, the regulatory frameworks in New Zealand, Australia, Hong Kong, and the United Kingdom with respect to offerors' ability to invoke defeating conditions and to rules around frustrating action by a target company.

	New Zealand	Australia	Hong Kong	United Kingdom
Invoking defeating conditions	Offeror may include any conditions in offer, but not those in own judgement or control. Guidance Note: should not include conditions that restrict target's ordinary course of business No restrictions on offeror invoking conditions to defeat offer.	Offeror may include any conditions in offer, but not those in own judgement or control.[9] The Panel may declare unacceptable circumstances if it is unreasonable for an offeror to rely on a defeating condition.[10]	Offeror may include any conditions in offer, but not those in own judgement or control.[11] Offeror may only invoke defeating condition if circumstances material in context of offer.[12]	Offeror may include any conditions in offer, but not those in own judgement or control. Offeror may only invoke defeating condition if circumstances material in context of offer.[13] Offeror must use all reasonable efforts to satisfy conditions.[14]
Frustrating action	Action prohibited that *could effectively* mean offer frustrated or shareholders denied opportunity to consider merits. Bona fide attempts to solicit other offers allowed. Action allowed if: (a) approved by shareholders; or (b) prior contractual obligation/ board approval; or (c) if (a) or (b) do not apply, if action unrelated to offer, with consent of Panel.	Whether triggering of a defeating condition means unacceptable circumstances depends on effect on shareholders and the market, in light of principles of the takeovers legislation.[15] Panel has jurisdiction to declare unacceptable circumstances. Guidance Note sets out likely scenarios that will be unacceptable (e.g., Share/option issues, major transactions).[16]	No action allowed that would result in offer being frustrated or shareholders denied opportunity to consider merits, unless approved by target's shareholders. [17] Panel Executive may waive shareholder approval requirement if action results from prior contractual obligation. Depends on circumstances.[18]	Action prohibited if it may result in offer being frustrated or shareholders denied opportunity to consider merits, unless approved by target shareholders. Certain transactions deemed prohibited (e.g., Share/option issues, major transactions).[19] Panel may consent if action results from pre-existing obligation or not fully implemented at time of offer.[20]

79. It is worthwhile to consider the position in Australia in greater detail. The Australian takeovers legislation (Chapter 6 of the Corporations Act 2001) is equivalent to the New Zealand Code so far as it relates to the kinds of conditions that an offeror may include in its takeover offer (i.e., the conditions cannot depend on the offeror's judgement or be in its control, or that of its associates). The Australian Takeovers Panel has a broad discretion to make a declaration of unacceptable circumstances in relation to the affairs of a company that is involved in a takeover transaction. Once such a declaration is made, the Panel may exercise its broad remedial powers. However, there is no outright prohibition against defensive tactics in the Australian legislation. Rather, the Australian Takeovers Panel has issued a Guidance Note that explains how the Panel deals with actions of the target company that may frustrate an offer.

80. The Australian Panel has indicated that it may make a declaration of unacceptable circumstances in certain cases where an offeror invokes a defeating condition in an offer if that may result in the offer being frustrated (i.e., the bid being withdrawn, or lapsing, or, if is only a potential bid, not proceeding to a formal offer). The Panel's Guidance Note on frustrating action states that, in considering whether a frustrating action gives rise to unacceptable circumstances, the Panel will consider, among other things, whether it is unreasonable for a bidder to rely on a defeating condition.

Options

81. The possible solutions to the problem identified above in respect of rule 25(1) and rule 38(1) of the Code are set out below.

Option 1: maintain the status quo

82. Under this option, offerors will continue to have a largely unfettered discretion as to whether to invoke a defeating condition (or waive it) if the relevant circumstances arise, resulting in heavy restrictions on the actions of the target company and its directors during the pre-offer, and offer, period.

83. One arguable benefit of the status quo is the flexibility it affords offerors. However, the Panel regards this as unbalanced as against the restrictions on the target company and its directors.

84. There are a number of other disadvantages with the status quo:

    (a) The problem of offerors being able to invoke defeating conditions with a largely unfettered discretion (thus providing an effective option over making an offer) is left unaddressed;

    (b) The New Zealand regime is an outlier compared with the regulation in Australia, Hong Kong, and the United Kingdom. In other words, conduct by a target company or its directors may be permitted in the overseas jurisdictions that would be prohibited by the New Zealand Code. Similarly, conduct by offerors may be prohibited in overseas jurisdictions that would be unchallengeable under the New Zealand Code; and

    (c) Whenever the directors of a target company wish to undertake an action that could give rise to the offeror invoking a defeating condition in its offer, the directors are compelled to rely on one of the provisos contained in rule 39 to avoid being in breach of rule 38(1) of the Code, which can be costly and time-consuming. This compliance burden is inappropriate if the target company is not engaging in defensive tactics.

85. The problems with these rules result in serious inefficiencies and uncertainties, especially for target company directors and shareholders, during hostile takeovers.

Option 2: Amend the Code to provide that Panel's consent required to invoke conditions

86. Under this option, the Panel would recommend to the Minister that the Code be amended to provide that an offeror could only invoke a defeating condition in its offer with the consent of the Panel.

87. This would partially bring New Zealand into line with overseas jurisdictions, where the respective takeovers rules allow only limited opportunities for offerors to invoke defeating conditions. However, there are disadvantages with this option. A party (e.g., an offeree, or the target company) may wish to contest the application by an offeror to invoke a defeating condition, and the most appropriate forum for the Panel to hear such a dispute may be a meeting under its enforcement provision in section 32 of the Takeovers Act.

88. In any event, in overseas jurisdictions the takeovers rules rely on an enforcement approach to the invoking of defeating conditions rather than an administrative application process. This seems appropriate, as having an application process would inevitably result in applications being made almost as a matter of course, which is a waste of resources for both the Panel and the applicant. For these reasons, this option is not considered to be optimal.

Option 3: Amend the Code to introduce restrictions on offerors invoking defeating conditions (preferred option)

89. Under this option, the Panel would recommend to the Minister that the Code be amended to prevent an offeror from invoking any condition in its offer that could cause the offer to not proceed, unless the circumstances that give rise to the offeror's right of invocation would reasonably be of material significance to the offeror in the context of the offer.

90. This approach has a number of advantages over the status quo:

    (a) It would ensure that a takeover offer could not be allowed to fail by an offeror for trivial or insignificant reasons. The offeror would effectively be under an onus to 'put its best foot forward' when it makes a takeover offer. This would encourage a more efficient capital market by ensuring that target company shareholders are given serious bids to consider, which may only lapse under triggered defeating conditions if there is a significant (material) change to the nature of the target company for the offeror;

    (b) There would be a reduced risk for the target company of being in breach of rule 38 of the Code for actions that are not defensive tactics. The materiality requirement in respect of the invocation of defeating conditions would raise the threshold from which an offeror may allow its offer to fail. In other words, the words relating to target company actions that "*could effectively result in…*" an offer being frustrated, contained in rule 38(1), would necessarily be read in light of the materiality test on the offeror to invoke a defeating condition. In effect, this is likely to mean that there are fewer restrictions on a target company during the course of a takeover offer. However, rule 38(1) would still catch genuinely defensive tactics. This would reduce the uncertainties for target companies and offerees, as well as ensuring the efficient operation of capital markets; and

(c) The New Zealand regulatory regime would be brought closely into line with Australia, the United Kingdom and Hong Kong, which are all major centres for mergers and acquisitions activity. The proposed change would, thus, also further the principles of business law co-ordination between Australia and New Zealand. The Panel would also be able to draw on the experience and jurisprudence in those overseas jurisdictions in its application of the proposed amendment in practice.[21]

91. There are, however, some disadvantages with the proposed amendment. Prospective offerors may be discouraged by the decreased flexibility for pulling their offer through the use of extensive offer conditions. The proposed materiality threshold requirement sets a standard that currently does not exist in the Code (in effect, offerors currently have an unfettered right to invoke defeating conditions in an offer) and could possibly result in fewer offers being made. This, however, works both ways. As noted above, the proposed amendment would improve certainty for shareholders and target companies that opportunistic offers would not lapse by virtue of some fairly minor matter, and it would also encourage potential bidders to make a serious commitment to the bid, given the limited circumstances in which they would be permitted to allow the bid to fail or be withdrawn.

92. On balance, the Panel believes that the preferred option would significantly improve the efficiency of the Code and contribute to the efficiency of the capital markets, and the potential disadvantages for offerors are outweighed by the advantages for target companies, their directors, and shareholders.

Section D – Questions to consider:

1. Do you agree that the discretion afforded to offerors under rule 25(1) of the Code is inappropriate? If so, why? If not, why not?

2. Do you support the Panel's preferred option? If so, why? If not, why not?

3. Do you have any other comments that you wish to contribute?

E. Requirement for a further independent adviser's report

The problem

93. Rule 22 of the Code relates to the requirements to obtain an independent adviser's report if a takeover offer is made for a Code company that has more than one class of equity securities on issue. Broadly speaking, if the offeror is making an offer for such securities, it must obtain an independent adviser's report that certifies that the offer is fair as between the different classes of securities.

94. The Panel has noted a potential anomaly in the Code with regard to the requirement for an offeror to obtain a further independent adviser's report where an offer has been made for more than one class of securities, and the offeror wishes to vary the terms of the offer.

95. Rules 27 to 32 of the Code prescribe various requirements in respect of the variation of offers made under the Code. Briefly, the offeror may vary the offer to either: increase components of the consideration, add a cash component to the consideration, add a cash alternative to the consideration, or extend the offer period. The offeror must issue a variation notice if it wishes to vary the offer.

96. Rule 30 of the Code provides, in effect, that if the offeror varies its offer in respect of the consideration,[22] and the offer includes offers for more than one class of securities, the offeror must obtain a further report from an independent adviser certifying that the offer is (still) fair and reasonable as between the classes of securities included in the offer.[23] The purpose of the further report is to ensure that offerees in one class of security are treated fairly vis-à-vis the offerees in another class of security, following the variation. The further report must be included with the variation notice. If the offeror varies the offer by increasing the consideration, any offerees who accepted the offer for the prior, lesser, consideration must be paid the additional consideration.[24]

97. There has been one instance where the Panel was asked to grant an offeror an exemption from the requirement to obtain a further report following a variation, as required by rule 30. The offer was made for all equity securities on issue by the target company, which included ordinary shares and mandatory convertible notes. The offer documentation included a report for the purposes of rule 22. Some weeks after the offer was made, the notes converted into ordinary shares. Under the terms of the offer, acceptances in respect of the notes became acceptances in respect of the resulting ordinary shares.

98. The offeror then wished to vary its offer to increase its offer price. The offeror sought an exemption from the Panel from the requirement to obtain a further report, given that at the time of the variation the target company now had only one class of equity security on issue. The Panel initially approved the exemption sought by the offeror.[25]

99. However, on a later reconsideration of the issue, the Panel formed the view that rule 30 should be read purposively so that, in the case referred to above, an exemption would be unnecessary. The Panel considered that other classes of voting securities could only be "included" in an offer, as anticipated by rule 30, where the offer has settled, or could ultimately settle, in respect of those other classes of securities (provided that the offer

terms were consistent with that outcome, and regardless of whether or not those securities had since ceased to exist).

100. Although the particular matter was resolved by the Panel applying a purposive interpretation to rule 30, the Panel nevertheless considers that there may be a lack of clarity surrounding the application of rule 30 of the Code.

Options

101. The following options for addressing the problem have been identified.

Option 1: Maintain the status quo

102. Under this option, the Panel would continue to apply a purposive interpretation to rule 30 of the Code. If an offeror made an offer which included more than one class of securities, and one of those classes ceased to exist subsequent to the offer being made, and there had been no acceptances by holders of that class (or appropriate conversion and consideration terms were included in the offer terms) and the offeror wished to vary the offer consideration, the offeror would not have to obtain a further report from an independent adviser to certify that the varied consideration was fair and reasonable as between the classes of securities under offer.

103. This option does not meet the policy objectives because rule 30 is confusing and, on its face, appears to require a further adviser report even though there is only one class of securities subject to the increased offer consideration. Although a purposive interpretation can resolve the problem, the obligations of offerors under the Code should be clear, to avoid confusion.

Option 2: Amend the Code (preferred option)

104. Under this option, the Panel would recommend to the Minister an amendment to the Code to clarify that, if an offer has been made for more than one class of security, and the offeror varies the offer consideration, the offeror does not have to obtain a further report from an independent adviser regarding the fairness as between the classes if the increased consideration now relates to only one class of securities (due to the other class(es) having ceased to be included in the offer because they no longer exist, in accordance with the Code and the terms of the offer). The proposed amendment would remove any doubt about the correct interpretation of rule 30 of the Code. It would reduce any potential confusion for investors in Code companies and improve the efficiency of the Code.

Section E – Questions to consider:

1. **Do you agree that there is an anomaly in rule 30 of the Code? If so, why? If not, why not?**

2. **Do you agree with the Panel's preferred option? If so why? If not, why not?**

3. **Do you have any other comments you would like to contribute?**

F. Acceptances by the offeror

The problem

105. Rule 35 of the Code provides:

> ***"Dispositions***
> *During the offer period, neither the offeror nor any person acting jointly or in concert with the offeror may dispose of any equity securities in the target company other than to an offeror under another offer that is made under this code."*

106. The purpose of rule 35 of the Code is to prevent an offeror, or any person who is acting jointly or in concert with the offeror, from taking steps to defeat the offer by way of disposing of securities it holds in the target company (the offeror could achieve this if it reduced its holding to such a level that it could not satisfy the minimum acceptance condition in its offer).

107. A problem with rule 35 typically arises, however, where the offeror, who already holds or controls voting rights in the target company, wishes to use a special purpose vehicle or a related person to make an offer under the Code. Rule 35 prohibits an offeror from "selling in" its voting securities into its own offer. Moreover, there may be other persons who hold or control voting rights in the target company and wish to accept into an offeror's offer, but for various reasons may be considered to be acting jointly or in concert with the offeror. In this case, those persons are prohibited from accepting the offer, by rule 35.

108. There have been six instances to date where offerors have encountered this problem with rule 35. This has led to the Panel granting exemptions for each of these transactions.[26] The usual condition to such an exemption is that the offeror, or any other person acting jointly or in concert with the offeror does not dispose of any equity securities in the Code company other than into the offeror's relevant offer or any other offer made by a third party in accordance with the Code.

109. In short, the exemptions from rule 35 of the Code have been sought and granted because of a drafting anomaly in the Code.

Options

110. The following options for addressing the problem have been identified.

Option 1: Maintain the status quo

111. Under this option, the Panel would continue to grant exemptions from rule 35 on a case-by-case basis. This would not, however, resolve the problem with the Code. The use of a special purpose vehicle to carry out a takeover offer is a relatively commonplace and acceptable commercial arrangement. Likewise, it is not uncommon for shareholders in a target company to be acting jointly or in concert with an offeror (for example, in a management buy-out). The Code ought to facilitate these kinds of transactions, which contribute to an efficient capital market in New Zealand. Rule 35 under its current form acts as an impediment to this. It also increases compliance costs for market participants

who are compelled to seek an exemption from the Panel. For these reasons, the Panel believes that it is not optimal to maintain the status quo.

Option 2: Amend the Code (preferred option)

112. Under this option, the Panel would recommend to the Minister an amendment to rule 35 of the Code along the lines adopted in the exemptions that have been granted. This could easily be achieved as follows:

> ***"35 Dispositions***
> *During the offer period, neither the offeror nor any person acting jointly or in concert with the offeror may dispose of any equity securities in the target company other than to* <u>*the offeror or to*</u> *an offeror under another offer that is made under this code."*

113. The proposed amendment would mean that the Panel would no longer need to grant exemptions from rule 35. This would reduce compliance costs for market participants, thereby contributing to a more efficient Code and a more effective capital market.

Section F – Questions to consider:

1. Do you agree that there is a problem with rule 35 of the Code? If so, why? If not, why not?

2. Do you agree with the Panel's preferred option? If so, why? If not, why not?

3. Do you have any other comments that you wish to contribute?

[1] Takeovers Act 1993. s (8)(1)(a).
[2] The definition of "equity security" includes other forms of securities, but they are not relevant here.
[3] There are exceptions to this definition, but none of them are relevant here: see rule 3(1).
[4] Takeovers Panel, *Guidance Note – The Takeover Panel's exemption power* (January 2005). Available online at http://www.takeovers.govt.nz.
[5] Rule 64(1) of the Code.
[6] While professional underwriters can rely on the *Takeovers Code (Professional Underwriters) Exemption Notice 2004*, and need not obtain shareholder approval, it is relatively common for share issues to be underwritten by an existing shareholder rather than by a professional underwriter.
[7] Prior to the granting of the class exemption, the Panel granted a large number of exemptions from rules 7(d) and 16(b) on a case-by-case basis.
[8] Available online at http://www.takeovers.govt.nz.
[9] Corporations Act 2001, s 629(1). The Corporations Act contains other exceptions in respect of the offeror's discretion to set the conditions to the offer. The other exceptions are not relevant here.
[10] Australian Takeovers Panel, *Guidance Note 12 – Frustrating action* (2nd issue, 11 February 2010) page 4.
[11] Code on Takeovers and Mergers and Share Repurchases (Hong Kong) (the "Hong Kong Code"), Rule 30.1,
[12] Hong Kong Code, Rule 30.1, Note 2.
[13] City Code, Rule 13.4(a).
[14] City Code, Rule 13.4(b).
[15] Australian Takeovers Panel, *Guidance Note 12*, page 3.
[16] Australian Takeovers Panel, *Guidance Note 12*, page 5.
[17] Hong Kong Code, Rule 4.
[18] Hong Kong Code, Rule 4, Note 4.
[19] City Code, Rule 21.1.
[20] City Code, Rule 21.1.
[21] For instance, the UK's Panel on Takeovers and Mergers has issued guidance on the application of its rules on the invocation of defeating conditions: *Practice Note No.5 Rule 13.4(a) – Invocation of Conditions* (30 April 2009) Available online at http://www.thetakeoverpanel.org.uk.
[22] This rule does not apply if the variation extends the offer period.
[23] Under rule 22 of the Code, the offeror would have had to have obtained a report when it made its initial offer, that certified that the offer was fair and reasonable as between the classes of securities.
[24] Rule 31(1) of the Code.
[25] The exemption, however, was never formally granted. It was effectively overtaken by events.
[26] *Takeovers Code (Cynotech Holdings Limited) Exemption Notice (No 2) 2009*, *Takeovers Code (Mr Chips Holdings Limited) Exemption Notice 2008*, *Takeovers Code (Kidicorp Group Limited) Exemption Notice 2008*, *Takeovers Code (Dairy Trust Limited) Exemption Notice* 2008, *Takeovers Code (CanWest MediaWorks (NZ) Limited) Exemption Notice 2008*, *Takeovers Code (Mike Pero Mortgages Limited) Exemption Notice 2006*.