THE CODE AND HOSTILE TAKEOVERS

A CONSULTATION PAPER ISSUED BY THE TAKEOVERS PANEL

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INTRODUCTION

1. This Discussion Paper addresses issues with compliance with the Code arising from hostile takeovers.

2. Part One of the paper discusses the problem that rule 25(1) of the Code, which regulates the conditions that the offeror may include in an offer, is out-of-balance with rule 38, which relates to defensive tactics engaged in by the target company to frustrate a takeover offer or to deny the shareholders an opportunity to consider the merits of a takeover offer.

3. In June 2010, the Panel conducted public consultation on issues that had been identified with rules 25(1) (offer conditions) and 38(1) (defensive tactics) of the Code, together with other 'technical' issues. The submissions received on the June Discussion Paper expressed a divergence of opinions on the Panel's preferred option for the rule 25(1)/rule 38(1) issue.

4. This discussion paper proposes a revised preferred option for resolving the problem, which more closely aligns the New Zealand regime with that in Australia.

5. Part Two of the paper discusses the problem encountered by target companies in resolving disputes with offerors over the reimbursement of the target company's expenses incurred in relation to a takeover offer. Amendments to the Takeovers Act 1993 are proposed, to provide the Panel with the jurisdiction to determine disputes over the reimbursement of a target company for its takeover expenses.

6. Part Two also considers rectifying a definition problem that arose in 2006, due to an inadvertent consequence of other amendments that were made to the Act at that time.

Request for comments on this paper

7. The Panel invites submissions on the preferred options in this paper. The closing date for submissions is **Thursday, 10 February 2011**.

8. Submissions should be sent to the Takeovers Panel:

   - By email - takeovers.panel@takeovers.govt.nz
   - By post - Takeovers Panel
     Level 3, Solnet House
     70 The Terrace
     P.O. Box 1171
     WELLINGTON
   - 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.

PART ONE:

OFFER CONDITIONS AND DEFENSIVE TACTICS

Introduction

1. In June 2010, the Panel conducted public consultation on issues that had been identified with rules 25(1) and 38(1) of the Code (the "June Discussion Paper"). The problem relates to whether rule 25(1), which regulates the conditions that the offeror may include in an offer, is out-of-balance with rule 38 of the Code, which relates to defensive tactics engaged in by the target company to frustrate a takeover offer or to deny the shareholders an opportunity to consider the merits of a takeover offer.

2. The Panel's preferred option to address this problem – which is explained in further detail below – was to amend the Code to prevent an offeror from invoking any condition (and so causing the offer to lapse or not proceed), unless the circumstances that gave rise to the offeror's right of invocation could reasonably be considered to be of material significance to the offeror in the context of the offer.

3. The submissions received by the Panel on the June Discussion Paper expressed a divergence of opinions on the Panel's preferred option. Accordingly, the Panel has carried out further research and analysis of the issue with a view to refining its preferred option. The purpose of this discussion paper is to seek comments from market participants on the Panel's refined preferred option. Briefly, the refined preferred option shows more clearly the Panel's intention to bring the defensive tactics regime in the Code more closely into line with the one that exists in Australia under Chapter 6 of the Corporations Act 2001.

Problem identification

4. 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.

5. Rule 39 of the Code prescribes exceptions 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 have approved 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, of the target company, 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.

6. 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 by the target company directors that *could effectively* defeat a takeover offer. This is a broad expression and focuses on the potential outcome of the action taken, regardless of the directors' intentions.

7. An example of how in the past the Panel has applied the prohibition in rule 38(1) was in respect of a takeover offer for Otago Power Limited. The Panel determined that the refusal by the directors of the target company to register the transfer of shares, under a takeover offer, to the offeror was a defensive tactic which contravened rule 38(1) of the Code.[1]

8. Under rule 38(1), the conduct does not need to *actually* lead to the offer failing or not proceeding. 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.

9. The risk is particularly acute in relation to the triggering of "defeating" conditions in an offer. Under the Code, an offeror has a broad discretion to include any conditions it wishes in its offer, 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.[2] The conditions in an offer document describe the circumstances in which the offeror is entitled to allow its offer to lapse or not proceed (although conditions may be expressed as being waivable and, in that case, the offeror can waive its right to rely on the condition). 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.

10. There may be circumstances where it would be unreasonable for a bidder to invoke or rely on a defeating condition in an offer, or a condition could be triggered by an event which was not of material significance to the offeror in the context of the offer. Regardless of the materiality or reasonableness, currently the offeror may invoke or rely on its condition and allow its offer to lapse, thereby ending the takeover. For example, an offer could include a condition that during the pre-offer and offer periods the target company cannot enter into any transaction (such as the sale or purchase of an asset) above a prescribed value. This value could be low in relation to the business activities of the

[1] *Otago Power Limited – Determination* (19 May 2002). Available online at http://www.takeovers.govt.nz, under Decisions.
[2] Rule 25(1) of the Code.

target company. It is conceivable that the target company could enter into a relatively minor transaction during the pre-offer or offer period of a takeover and, in doing so, give rise to a right for the offeror to invoke or rely on a defeating condition.

11. The Panel has sought to mitigate this risk. In *Code Word No. 16* (May 2006),[3] the Panel issued a Guidance Note on "restrictive" offer conditions. The Guidance Note comments on the possibility that a condition could be so restrictive that it prevents 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. The Guidance Note has encouraged the market practice of offerors including, in restrictive conditions in an offer, a proviso that the target company may carry out its ordinary business during the period of the takeover offer.

12. A Guidance Note, however, can only encourage a practice in the market. The limits of the proviso in rule 25(1) have not been formally tested. The broad flexibility available to offerors under the Code for the inclusion of defeating conditions can create uncertainty regarding whether an offer will lapse.

13. Moreover, any action taken or permitted by the directors of the target company which could trigger a defeating condition is an action that *could effectively* result in the shareholders not having an opportunity to consider the merits of the takeover offer. Accordingly, when coupled with the rigidity of the prohibition against defensive tactics by a target company, the wide discretion for offerors to invoke or rely on defeating conditions puts the directors of the target company in a 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. While this risk can usually be managed in a 'friendly' takeover situation, it can be very difficult in a hostile takeover.

14. As noted above, rule 39 of the Code provides mechanisms for the target company to carry out an action that would otherwise be prohibited by rule 38(1). The most significant problem is that even if the directors are able to rely on a proviso in rule 39 the offeror may still invoke a triggered defeating condition and allow the offer to lapse. The provisos in rule 39 only protect the directors of the target company from otherwise being in breach of rule 38 of the Code – the provisos do not ensure that a takeover will continue.

Australian regime

15. 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 (or its associates') judgement or be in its (or its associates') control.

16. However, in Australia there is no legislation which corresponds to the defensive tactics provisions in the New Zealand Takeovers Code. 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, which include preventing an

[3] Available online at http://www.takeovers.govt.nz, under Publications.

action or transaction from proceeding, requiring the target company to seek shareholder approval of an action or transaction, or requiring a transaction or action to be unwound.[4]

17. The Australian Panel's approach to defensive tactics, or frustrating actions, is set out in *Guidance Note 12 – Frustrating action* (a copy is **attached** as Appendix **A**).

18. The Australian Panel defines a "frustrating action" as any action by a target company, whether taken or proposed, by reason of which a takeover offer may be withdrawn or lapse, or a potential offer is not proceeded with.[5] The Australian Panel considers that whether a frustrating action gives rise to unacceptable circumstances (such that the Panel may exercise its powers) will depend on its effect on the shareholders of the target company and the market in light of the following principles of the Australian takeovers legislation:

    (a) That the acquisition of control over voting shares takes place in an efficient, competitive, and informed market; and

    (b) That, as far as practicable, the shareholders of the target company all have a reasonable and equal opportunity to participate in any benefits from an offer to acquire a substantial interest in the target company.[6]

19. The Australian Panel has identified certain actions by a target company involved in a takeover, which may give rise to unacceptable circumstances (for example, issues of new securities by the target company, the target company undertaking a major transaction, or the target company declaring an abnormally large dividend).

20. The Australian Panel considers that any action which triggers a condition in an offer is a frustrating action.[7] In determining whether the action gives rise to unacceptable circumstances, the Panel has stated that it will be guided by considerations surrounding the offer and the frustrating action.

21. Among other things, the Australian Panel will consider whether it is unreasonable for the offeror to rely on the relevant defeating condition. The Australian Panel is clear that an offeror is free to choose whatever offer conditions it wants (provided that they are not within its judgement or control). However, the Panel gives as examples of circumstances which may be unacceptable, the cases of an offeror who invokes a condition unreasonably (the grounds for invocation not being commercially critical to the offer), or of conditions that are overly restrictive of the activities of the target company. The Panel considers that an offeror must accept that the target company's normal business can continue during the course of a takeover offer.[8]

Comparison of Australian approach with the New Zealand Code

22. The key differences between the Australian and New Zealand regimes is the broad discretion held by the Australian Panel to declare unacceptable circumstances (in light of

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[4] Corporations Act 2001 (Australia), s 657D.
[5] Australian Takeovers Panel, *Guidance Note 12 – Frustrating action* (2nd issue, 11 February 2010), page 2.
[6] Ibid, page 3.
[7] Ibid, page 2.
[8] Ibid, page 4.

the governing principles of Chapter 6 of the Australian Corporations Act), and the inclusion of rule 38 in the New Zealand Code (which is absent from the Australian legislation).

23. This is particularly relevant in respect of the triggering of defeating conditions. Under the Code in New Zealand, if the directors of the target company take or permit any action that gives an offeror the right to invoke a defeating condition, rule 38(1) of the Code will be engaged. Accordingly, the action would be prohibited unless one of the provisos in rule 39 could apply. In Australia, the Panel would consider the impugned action by the directors in light of the principles of Chapter 6 (i.e., the effect on the market, the effect on shareholders of the target company etc.), and its powers to declare unacceptable circumstances.

24. The difference is stark in respect of a defeating condition that is invoked by the offeror unreasonably (say, for example, in relation to a minor or commercially insignificant matter) or where the offeror invokes an overly restrictive condition. In Australia, the Panel's Guidance Note indicates that it would likely give rise to unacceptable circumstances by the offeror to invoke such conditions and thereby effectively itself frustrate the offer. Accordingly, it is likely that the Australian Panel would make orders that the offeror continue with its offer.

25. In New Zealand, this could not happen. The directors of the target company (who may be acting bona fide) would not be complying with rule 38(1) of the Code by bringing about circumstances which resulted in a right of invocation of a defeating condition by the offeror. Moreover, the offeror would be acting within its rights to allow its offer to lapse or to not proceed.

Summary of problem identification

26. The Panel has identified a problem with rules 25(1) and 38 of the Code. Rule 38(1) prohibits the directors of a target company from taking or permitting an action that *could effectively* result in frustration of a takeover offer or the shareholders of the target company being denied an opportunity to decide on the merits of the offer. Accordingly, the rule catches conduct which may give rise to an offeror being able to invoke or rely upon a condition in its offer to allow the offer to lapse or not proceed. There is a possibility that this could occur in respect of a condition that is overly restrictive of the business activities of the target company, or a condition which is invoked or relied upon by the offeror unreasonably. This outcome would not occur under the regime that exists in Australia under Chapter 6 of the Corporations Act 2001.

Policy objectives

27. The Panel's policy objectives for the proposals discussed below are to ensure the Code's defensive tactics rules are effective and efficient, to increase certainty for investors in target companies, and to facilitate the efficient operation of New Zealand's capital markets.

Options

28. The July Discussion Paper proposed three options for addressing the problem. They are briefly described, below.

29. The first option was to maintain the status quo. However, this had a number of disadvantages. Most importantly, it would leave unresolved the problem of offerors, effectively, being able to frustrate an offer by including unreasonably restrictive defeating conditions. The provisos in rule 39 of the Code do not resolve the problem: even if the directors of the target company can rely on a proviso to rule 39(1), the offeror is still entitled to invoke or rely on its condition to allow the offer to lapse or not proceed. Finally, the regime in New Zealand would continue to be out of line with that which exists in Australia.

30. The second option was a proposal to amend the Code so that an offeror could only invoke a defeating condition in an offer if it had the consent of the Panel. The benefit for the shareholders of the target company of this proposal is that it would increase the difficulty for offerors to invoke conditions, which would have the effect of mitigating, to some extent, the identified problems. However, the Panel considered that it would be likely that applications for consent would be contested in the event of a hostile takeover. The most appropriate forum for the Panel to hear such a dispute would be a meeting under section 32 of the Takeovers Act. It would be inappropriate for the Panel to consider a dispute under an administrative application process.

31. The Panel's preferred option (the third) for addressing the problem was 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.

32. The Panel considered that the preferred option had the following advantages over the status quo:

    (a) It would ensure that a takeover offeror could not allow its offer to fail for trivial or insignificant reasons. This would encourage a more efficient capital market by ensuring that target company shareholders are given serious offers to consider, without the risk of an offer lapsing or not proceeding for an insignificant or immaterial reason;

    (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 intended to be 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 would likely mean that there were 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 the capital markets; and

(c) The New Zealand regulatory regime would be brought closely into line with Australia, and other 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 of those overseas jurisdictions in its application of the proposed amendment in practice.

33. The Panel noted that there were disadvantages with the proposed amendment. Prospective offerors may be discouraged by the decreased flexibility if they were no longer able to pull 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.

Refinement of the preferred option

34. Having taken into account concerns expressed by submitters on the June Discussion Paper, the Panel has refined its preferred option for addressing the problem. The Panel now proposes that the Code be amended to more clearly align with the Australian regime, so far as it relates to defeating conditions in an offer.

35. Accordingly, the preferred option is to recommend to the Minister that provisions be inserted into rule 25 of the Code (probably as new rules 25(1A) and 25(1B)) along the following lines:

Conditions

25(1) *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.*

25(1A) *An offer must not be made subject to a condition which restricts the target company from carrying out activities in the ordinary course of its business during the period following the sending by an offeror of a notice under rule 41 of the Code and the close of the offer period in accordance with this Code.*

25(1B) *An offeror must not unreasonably invoke or rely on any condition in an offer made under this Code.*

36. The Panel will publish a Guidance Note which explains the changes to rule 25(1) of the Code. A draft version of the Panel's Guidance Note is **attached** as Appendix **B**. The Panel welcomes feedback on the draft Guidance Note.

Analysis of the preferred option

37. The refined preferred option would work as follows. Firstly, it would bring into law the outcome sought to be achieved in the Panel's Guidance Note in *Code Word 16* in respect of restrictive offer conditions. In other words, an offeror would breach the Code if it included a condition in its offer which purported to restrict the target company from carrying out its ordinary business activities during the offer, and pre-offer, period. In a dispute, the Panel would determine whether an offer condition was overly restrictive, in breach of rule 25(1A), or whether an action by the target company was undertaken in the company's "ordinary course of business". These matters would be determined in the circumstances of the particular case. "Ordinary course of business" is a concept well-developed in commercial law and widely understood by market participants.

38. Secondly, an offeror would be prohibited from unreasonably invoking or relying on a condition in an offer so as to cause an offer to lapse or to not proceed. For example, it would be unlikely that an offeror could rely on a minor and commercially insignificant event to justify invoking or relying on a condition in the offer.

39. The draft Guidance Note (which is attached to this Discussion Paper) includes more information about how the new rules will work.

40. The proposed new rules address the difficulty raised by the words *"could effectively"* contained in rule 38(1) of the Code. Under the status quo, if directors of a target company engage in or permit any action which could give rise to an offeror invoking a defeating condition in an offer, the directors *could effectively* be frustrating a takeover offer, even if that action is not a genuinely defensive tactic. The proposed rule changes place reasonable and fair limits on the ability of an offeror to invoke a defeating condition.

41. Accordingly, the directors may no longer need to rely on one of the provisos contained in rule 39 of the Code in respect of bona fide conduct. Or, where it is necessary or prudent for the directors to make a potentially frustrating action conditional on shareholder or Panel approval (under rule 39(a) or (c), respectively), the offer may still remain on foot for the shareholders to consider.

42. The new preferred option would have the same advantages as the earlier preferred option referred to at paragraph 32, above. Namely:

    (a) It would remove the risk that an offer could lapse or not proceed on the grounds of the triggering of a defeating condition where reliance on that condition by the offeror would, in the circumstances, be unreasonable;

    (b) It would relieve the directors of the target company of potential non-compliance with rule 38(1) of the Code in respect of actions that were not genuinely defensive tactics; and

(c) It would bring greater consistency between the regulatory regimes of New Zealand and Australia.

43. A further advantage of the revised preferred option is that there would be greater certainty that offer conditions could not overly restrict or limit the target company from engaging in its ordinary business during the period of the takeover offer. In other words, the proposal resolves the problem that the Panel's Guidance Note on restrictive conditions addresses. It clarifies that an offer condition cannot be overly restrictive of the ordinary activities of the target company. Under the proposal, an offeror is free to include any other conditions provided they comply with the proviso in rule 25(1) of the Code.

44. The revised preferred option more clearly adopts the approach taken in Australia. Accordingly, the New Zealand Panel and market practitioners would be able to draw upon the experience and jurisprudence in that jurisdiction. This should alleviate concerns about the application of the proposal in practice. Moreover, the revised preferred option is not a radical change from the status quo. It serves to introduce more clarity and fairness to the Code and should not require significant changes to market practice. It seeks only to remove the risk of an offer being aborted unreasonably or on some insignificant or immaterial ground, and to balance the defensive tactics rules to which a target company is subject with a more controlled approach to the offeror's ability to let the offer lapse.

Consultation

45. The Panel received submissions on the June Discussion Paper from four major commercial law firms as well as the New Zealand Law Society.

46. A significant concern of the submitters regarding the earlier preferred option was that it introduced a new concept into the Code – a materiality threshold in respect of the invocation of defeating conditions. This aspect of the preferred option was the subject of much discussion in the submissions. Submitters expressed concerns about possible interpretations that the Panel could adopt in applying the materiality threshold, and that this could have ramifications for market activity. If the Panel set a high threshold of materiality, it could stifle the making of offers which may, in other circumstances, have been made.

47. The revised preferred option addresses this concern. The proposed new rules do not introduce a high or insurmountable threshold for the invocation of defeating conditions by an offeror. An offeror may include any conditions it wishes, to ensure that it can stop the bid in appropriate circumstances, provided that the conditions:

(a) do not depend on the judgement, and are not within the power, of the offeror, or the offeror's associates;

(b) do not restrict the target company from carrying out activities in the ordinary course of its business during the offer, and pre-offer, period; and

(c) are not invoked unreasonably.

48. Submitters were broadly supportive of the Panel's effort to strike the right balance between the legitimate right of offerors to not proceed with an offer in cases where there

has been a fundamental change to the relevant circumstances of the offer, and reducing the scope for offerors to include immaterial or strategic conditions which create uncertainty for the target company and its shareholders (the offerees).

49. Submitters were supportive of the Panel's proposal to align New Zealand's regime with that of Australia. The new preferred option more clearly adopts the Australian approach. Accordingly, the new preferred option aligns with the expectations of the submitters.

PART ONE – QUESTIONS

1. Do you agree that there is a problem with rule 25(1) of the Code being out-of-balance with rule 38(1) of the Code?
2. Do you support the Panel's revised preferred option? If so, why? If not, why not?
3. Do you have any other comments or suggestions which you would like to contribute?

PART TWO:

A: TARGET COMPANIES' REIMBURSEMENT OF TAKEOVER EXPENSES;
B: TECHNICAL ISSUE - THE DEFINITION OF CODE COMPANY

A: TARGET COMPANIES' REIMBURSEMENT OF TAKEOVER EXPENSES

Introduction

1. On 12 October 2010 judgment was given on the judicial review of the Takeovers Panel, instigated by Marlborough Lines Limited ("Marlborough"), that was heard in the High Court in Wellington on 9 – 11 August 2010 ("the *Marlborough Lines* case").[9] The second defendant in the proceedings was Horizon Energy Distribution Limited ("Horizon"), the target company for which Marlborough had made a takeover offer late in 2009. The takeover failed.

2. One of the matters in respect of which Marlborough had sought judicial review was a decision by the Panel to hold a meeting under section 32 of the Takeovers Act 1993,[10] on the request of Horizon, to consider whether Marlborough had breached rule 49(2) of the Code in failing to pay the sum claimed by Horizon for costs incurred in relation to the failed takeover.[11] Marlborough claimed that the Panel does not have jurisdiction to determine matters relating to rule 49(2).

Problem identification

3. Rule 49 of the Code provides as follows:

   (1) Despite anything in the constitution of the target company, each director of the target company is entitled to have refunded to the director by the target company any expenses properly incurred by the director on behalf, and in the interests, of holders of equity securities of the target company in relation to an offer or a takeover notice that is made or given under the Takeovers Code.

   (2) The target company may recover from the offeror, as a debt due to the target company, any expense properly incurred by the target company in relation to an offer or takeover notice, whether as a result of refunds made under subclause (1) or otherwise.

4. This rule replicates the statutory right that used to be available under section 11 of the Companies Amendment Act 1963 (which was repealed when the Code came into

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[9] *Marlborough Lines Limited v Takeovers Panel & Ors* (CIV-2010-485-1150), MacKenzie J.
[10] Section 32 provides the Panel with the power to call a meeting to determine whether a person has breached the Takeovers Code.
[11] Rule 49 of the Code provides that the target company may recover from the offeror, as a debt due to the target company, any expenses properly incurred by the target company in relation to a takeover offer.

force) in relation to takeover schemes put forward under that Act. Prior to the establishment of the Panel under the Takeovers Act, and the coming into force of the Code, the only way for target companies to recover their takeover expenses was through an action in Court for debt recovery.

5. There is no rule in the Code that requires the offeror to pay to the target company the expenses claimed under rule 49(2).

6. The policy of rule 49 is to discourage vexatious or ill-conceived bids, due to the adverse impact that a takeover can have on a Code company's business operations and board activities. The rule also encourages bidders to 'play by the rules', because one of the expenses that a target company can properly incur in ensuring that shareholders have all the information they need to consider whether to accept or reject the offer is the countering of 'propaganda' by a bidder.[12] Ultimately, the bidder can be required to reimburse the target for all of the target's properly incurred takeover-related expenses.

7. In 2008 the Panel exercised the jurisdiction that it believed then that it had, to consider a rule 49 reimbursement dispute relating to a failed takeover for Abano Healthcare Group Limited ("Abano") by Crescent Capital Partners Limited ("Crescent").

8. Abano had requested the Panel to hold a section 32 meeting to determine the matter and had provided to the Panel detailed invoices in support of its claim, but, just before the hearing was due to be held, the parties settled the costs. The Panel did not, therefore, have the opportunity to provide guidance to the market about the types and quantum of expenses that could be considered to be "properly incurred", for the purposes of rule 49, through the forum of a determination made following the Abano/Crescent section 32 meeting. So, the Panel issued a Guidance Note in its periodic publication *Code Word*, in December 2008,[13] after public consultation, setting out in detail the Panel's views on the state of the law on recoverable takeover costs since the replacement of the Companies Amendment Act with the Takeovers Code, and the categories of expenses that could properly be claimed by a target company. A copy of the Guidance Note is **attached** as Appendix **C**.

9. The length and detail of the Guidance Note on recovering expenses under rule 49 of the Code highlights that determining the expenses that are "properly incurred" is a complex task. In particular, knowing where to draw the line on what is, and what is not, a properly incurred expense requires not only commercial expertise but also experience in mergers and acquisitions and the Takeovers Code.

10. As a result of the judicial review proceedings, the High Court has held that the Panel does not have jurisdiction to determine rule 49(2) claims for reimbursement by a target company.[14]

11. The judgment given by MacKenzie J acknowledges the potentially powerful policy argument that the Panel's specialist expertise in determining takeovers matters makes

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[12] *Canterbury Frozen Meat Company Ltd* v *Waitaki Farmers' Freezing Company Ltd* [1972] NZLR 806; *Code Word Number 24*.
[13] *Guidance Note: Recovery of expenses under rule 49(2) of the Code.*
[14] *Marlborough Lines*, paragraph [89].

it the most suitable body to determine rule 49 expenses. However, MacKenzie J held, on a consideration of principles of statutory interpretation, that the policy argument could not overcome the statutory indications that the Panel lacks the jurisdiction to make such determinations. [15]

12. Justice MacKenzie considered that the wording of rule 49 of the Code clearly indicates that a target company seeking to recover expenses under rule 49 has a right of access to enforce payment, which is not subject to the restrictions on access to the Court that are contained in section 35 of the Takeovers Act.[16] The right to recover expenses "*as a debt due*" is inconsistent with any requirement that the jurisdictional gateway in section 35 must be used to access the Court.

13. Justice MacKenzie also considered whether the Takeovers Act provided an *alternative* access to the Court for a rule 49 expenses recovery claim, in addition to the availability of ordinary Court proceedings for debt recovery. If it did, the Panel would have jurisdiction to settle rule 49 disputes if a target company requested it to hold a section 32 meeting on the non-payment by the offeror.

14. After considering the remedies available under the Takeovers Act, even assuming that the section 35 gateway has been effectively traversed, MacKenzie J concluded that the Takeovers Act remedies for a breach of the Code are not readily reconcilable with the power of the Court to order payment of a debt due,[17] and decided that rule 49 disputes cannot be determined by the Panel exercising its powers under section 32 of the Takeovers Act.

15. As a result of the High Court decision in relation to the rule 49 issue, the takeovers market is now left without the mechanism of the Panel's specialist expertise (as acknowledged by Justice MacKenzie) to determine the expenses properly incurred by a target company that must be reimbursed by an offeror.

16. Two issues need to be addressed when considering the problem that now exists.

17. Firstly, who is the most suitable body to consider, in a particular case, whether the expenses claimed by a target company were, in fact, "properly incurred"? In other words, if it is accepted that the Panel's Guidance Note in *Code Word Number 24* appropriately categorises the types of expenses that can be claimed under rule 49 of the Code, who has the expertise to apply those categories to the invoices presented by a claimant target company?[18]

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[15] *Marlborough Lines*, Paragraph [88].

[16] Under section 35 of the Takeovers Act an application can only be made to the Court if the Panel has held a section 32 meeting and determined that a person has breached the Code. Even then, the Panel must consent to the person making an application to the Court or, alternatively, the person can request the Panel to make an application to the Court and if it does not do so within 10 days of the request, then the person can make an application. If the Panel is requested to hold a section 32 meeting and does not make a determination within 14 days of that request, then a person can make an application to the Court. Finally, if the Panel determines that there has been no breach of the Code, no one can make an application to the Court (however, that Panel determination can be judicially reviewed under the Judicature Act 1908).

[17] *Marlborough Lines*, paragraphs [82] – [84].

[18] *Code Word Number 24* states, at page 7: "the Panel considers that before an item of expense can be allowed under rule 49(2) of the Code, the target company must prove that the following four elements have been satisfied:

18. Secondly, who is the most suitable body to *adjudicate* on the dispute between the target company and the offeror? In other words, although the answer to the first issue *may* lead to the same answer for the second issue, it may not. For example, despite the High Court acknowledging the policy arguments for the Panel being the most suitable body to determine rule 49 disputes, might it not be the case that the District or High Court *is* the most suitable body to adjudicate on the dispute, if the body identified in respect of the fist issue has undertaken the step of applying the 'law to the facts', to assist the Court?

19. When considering the magnitude of the problem, generally speaking, rule 49 disputes tend only to arise where a hostile takeover has failed. Accordingly, there may be about one or two such disputes a year (under normal market conditions).

Policy Objective

20. The policy objective for the proposals discussed below is to provide an efficient and effective mechanism for the resolution of target company expense-recovery disputes resulting from takeovers under the Code.

Options

Option 1: Maintain status quo

21. If no change is made to the law, the only way that target companies will be able to have their expense claims adjudicated is through the District or High Court. The main problems with using the ordinary Courts for adjudicating takeovers-related disputes relate largely to the cost and delays associated with specialist commercial litigation going through the general Courts.

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(1) Application of general principles of proper expenditure - that the expenditure falls under one of the following three categories:

i. Category 1 - Expenditure incurred in:
   - complying with the procedural requirements of the Code;
   - complying with the law and directors' fiduciary obligations which touch on the target company's response to a takeover.

ii. Category 2 - Expenditure incurred for the purpose of safeguarding the offerees' interests. Consistent with the law as set out in the Takeovers Code, the merits of a bid (with value representing a subset thereof) should be used as a key measure of the offerees' interests. This Category also includes expenditure incurred in countering propaganda ...

iii. Category 3 - Expenditure incurred in reimbursing directors for expenses properly incurred on behalf of, and in the interests of, the shareholders of the target company in relation to the takeover offer or takeover notice.

(2) Nature of expense reasonable - that it was reasonable (with reference to circumstances existing when the expense was incurred) to incur the expense by engaging in that kind of activity;

(3) Quantum of expense reasonable - that it was reasonable (with reference to circumstances existing when the expense was incurred) to spend that amount on that kind of activity; and

(4) Nexus with takeover - that there is a sufficient nexus between the incurring of the expenditure and the offer or the takeover notice."

22. A claim made under rule 49 might be worth anywhere between, say, $50,000, where perhaps a bidder gave a takeover notice but ultimately did not make a takeover offer, so the full range of expenses was not incurred by the target company, to around $200,000 to $300,000 or more, where an offer was made but it did not succeed.[19] The parties to the litigation would be likely to use expert witnesses, to argue the extent to which claimed expenses were or were not properly incurred, as Judges will need their assistance in coming to understand the needs of target company boards in a takeover situation. Thus, the specialised nature of rule 49 claims will add to the length of a hearing, also increasing legal costs. Accordingly, the cost of litigation can quickly escalate, potentially to beyond the level of target company expenses being recovered.

23. Since there is no apparent commercial urgency to having the dispute resolved, it can take years to have the matter heard in Court, at significant cost both in terms of the legal process and the drain on the target company's resources. By way of example, a rule 49 dispute relating to the failed takeover offer by Peter Yealands Investments Limited for Oyster Bay Marlborough Vineyards Limited was set down for a three day hearing in the High Court in June 2010 in relation to a takeover offer that had been made in 2005. Just before the hearing the parties settled out of Court.

24. Accordingly, the status quo leaves the problem unresolved. A flow on effect of this is that the policy behind rule 49, to discourage non-genuine or ill-conceived bids, is undermined.

Option 2: Give Panel a function in Act to resolve rule 49 claims using section 32 process

25. Option 2 is to provide in the Takeovers Act a clear function for the Panel to resolve rule 49 disputes. This could be achieved by inserting a new section 31Y into Part 3 of the Takeovers Act, along the following lines:

    "31Y Panel may determine claims for reimbursement of expenses by target company
    The Panel may, in accordance with its powers under section 32, consider whether a person may not have acted or may not be acting or may intend not to act in compliance with the takeovers code in relation to a claim by a target company under rule 49(2) of the code."

26. This would provide certainty that the Panel's processes could be utilised for hearing the dispute. The Panel would be funded for this through its ability to charge for its time spent on section 32 proceedings, under the Takeovers (Fees) Regulations 2001.

27. There would be no need for parties to use experts to opine on whether the target company's claimed expenses were properly incurred and the extent to which the quantum was reasonable, as the Panel is already an expert body on the topic (as acknowledged by Justice MacKenzie) and is qualified to make the determination unaided, save for the insights that a contradictor (the offeror) would provide at the hearing.

[19] It is possible that a *successful* takeover offer may result in a rule 49 dispute, but (outside of the rare cases of a partial offer for less than 50% of the company) it is unlikely to occur, as the target company will now be either fully owned by the bidder or at least a related company.

28. However, this is not the best option for a number of reasons.

29. Firstly, any finding that a person has breached the Code brings about reputational loss for the breacher. That kind of stigma seems inappropriate and disproportionate for a dispute about expenses.

30. Secondly, as MacKenzie J highlights in the *Marlborough Lines* case, the remedies available under the Takeovers Act are not appropriate for the simple recovery of expenses after a takeover has ended. Accordingly, although the Panel's enforcement powers under the Takeovers Act can provide for a speedy and efficient *hearing* of a rule 49 dispute, the *resolution* of the dispute would remain in doubt. Neither the Panel, nor the High Court (if the section 35 gateway were used following a section 32 meeting on a rule 49 dispute) can order the offeror to reimburse the target company for expenses that the Panel has ruled were properly incurred. Option 2 would not meet the policy objective of providing an efficient and effective mechanism for the resolution of rule 49 disputes.

31. The lack of an appropriate remedy under the Takeovers Act would not appropriately be 'fixed' by simply adding, to the Panel's and the Court's available orders, one that enables a direction to the offeror to pay the target company the amount determined as owing. More than that would be needed.

32. Under Option 2, an amendment to the Code should be made, to put an obligation in the Code on an offeror to pay the target company its rule 49 expenses.[20] The new rule would then be breached as a result of the offeror not paying the amount claimed by the target (the trigger for holding a section 32 hearing is that a person may have breached a provision of the Code).

33. However, it may not be appropriate to include such an obligation as a rule of the Code. It could well be argued that there should not be an obligation imposed on an offeror to pay rule 49 expenses until, either by agreement between the parties or through adjudication, the amount that the target can claim, as expenses *properly incurred*, has been settled.

34. Another indicator that Option 2 does not provide an optimal solution to the problem is that the section 32 enforcement procedure is designed to deal with the 'accident and emergency' environment of a takeover or other Code-regulated transaction being in train. Hence, the timeframes around the holding of a section 32 meeting and the issuing of restraining orders and the making by the Panel of a determination are extremely short.[21] The whole design of section 32 puts significant strains on the resources of the Panel and the parties, but it is geared to enabling enforcement action

[20] For the 2008 Abano/Crescent section 32 meeting, this obligation on the offeror (Crescent) was assumed to flow from the right in rule 49 for target companies to claim reimbursement. In the *Marlborough Lines* case, at paragraph [77], MacKenzie J observed that rule 49 imposes no obligation on an offeror.

[21] If the Panel issues a notice of meeting for holding a section 32 meeting, then the section 32 meeting must be held within seven days of the sending of the notice (section 32(1) of the Takeovers Act). The Panel has only two days, from the start date of the meeting, to make its determination regarding whether there has been a breach of the Code, if it needs to issue restraining orders after the section 32 meeting (section 32(4) of the Takeovers Act).

to be taken while accommodating the transaction, so that the transaction is not derailed by protracted proceedings.

35. By contrast, a rule 49 expense claim will always be made after everything to do with the takeover has finished, ensuring that all of the target company's relevant expenses can be claimed for. There is not the sort of urgency for resolving the matter that section 32 of the Takeovers Act is designed to deal with. The commercial imperative is that the target company is reimbursed for the expense it was put to by the failed takeover. There is no need to operate under the section 32 'accident and emergency' procedures for this type of dispute.

Option 3: Give Panel a function to make recommendations to the Court on rule 49 debt recovery claims

36. Option 3 is to provide in the Takeovers Act a function for the Panel to make recommendations to the Court on rule 49 disputes. This could be achieved by inserting a new section 31Y into Part 3 of the Takeovers Act, along the following lines:

 "*31Y Panel may make recommendations to Court*
 The Panel may, at the request of the Court or of any person who is interested in relation to a claim by a target company under rule 49(2) of the code, make a recommendation to the Court about that claim."

37. In order to fund this activity, the Takeovers (Fees) Regulations 2001 would need to be amended so that the Panel could recover its costs for the time spent on considering and categorising the invoices presented by the target company. If the Government agreed that the Panel could use its Litigation Fund to appear in Court on rule 49 target company expenses disputes, that aspect of its role would be tax-payer funded. Alternatively, the Panel's role could be limited to a written recommendation, with no appearance in Court.

38. Under this option, the state of the law as determined in the *Marlborough Lines* case would remain unchanged, in that target companies would pursue their claims for recovery of expenses "as a debt due" through the ordinary Courts. However, if a party to the claim asked the Panel to make a recommendation to the Court, the Panel would have jurisdiction to do so.

39. The advantage of this option is that it disturbs the status quo only minimally, so there would be little in the way of compliance costs in terms of coming up to speed on the new provisions. Likewise, Option 3 would ensure that developments in the law on these kinds of disputes would have the benefit of the Court reporting system.

40. However, Option 3 would be unlikely to meet the policy objectives for resolving the problems with rule 49 for several reasons, including that it would:

    (a) not alleviate the problem of the costs and delay associated with ordinary, non-urgent Court proceedings, particularly since the offeror may still use expert witnesses to challenge the contents of a Panel recommendation and to try to minimise the expenses claimable by the target company;

(b) introduce an additional layer of costs to the requesting party, or to both parties if they agreed to jointly request a Panel recommendation, as the Panel would need to be able to fund this new function through recovering its costs from the requester(s);

(c) be difficult for the Panel to manage because, in the absence of hearing from both parties to the dispute, the Panel may not be confident that the quantum of the target company's claimed expenses was justifiable. Accordingly, the Panel's recommendations may be tentative (and therefore of lesser value to the Court) unless the Panel had itself had the benefit of a contradictor (i.e., the offeror) to test the robustness of the target company's claimed expenses. Under the latter scenario, the parties would face two hearings: firstly in front of the Panel, and then the Court.

41. For these reasons, Option 3 seems unlikely to be able to provide an efficient or effective mechanism for the resolution of target company expense-recovery disputes resulting from takeovers under the Code.

Preferred Option: Option 4: Give Panel a function in Act to resolve 'rule 49' claims, and a specific process for resolving the claims

42. The preferred option is to not only give the Panel a clear statutory function to determine target company reimbursement claims but also to give such claims their own statutory process. The proposal is that rule 49 be taken out of the Code and put into the Takeovers Act ("target company reimbursement claim"). The words "*as a debt due to the target company*" should be removed from subclause (2) of the target company reimbursement claim provision, as the Panel, not the ordinary Courts, would now clearly be the adjudicator.

43. Under this proposal, the Act would be amended to clearly make the Panel the primary adjudicator of target company reimbursement claims. The High Court would have a backup role of enforcing Panel determinations of target company reimbursement claims, much as it has for enforcing section 31T undertakings which are an enforcement tool used quite frequently, and to good effect, by the Panel.[22]

44. A consequential amendment would need to be made to the Takeovers (Fees) Regulations 2001, to enable the Panel to charge the parties for its time in considering these disputes, and to be able to apportion those costs against either or both of the target company or the offeror, as appropriate.

45. The new provisions for Panel enforcement of these costs disputes might be worded along the following lines:

"Target company reimbursement claims

31Y Reimbursement of directors and target company

[22] Under section 31T of the Act, the Panel may accept a written undertaking from a person, in connection with any matter in relation to which the Panel is exercising any of its functions or powers. Under section 31U, if the Panel considers that a person has breached a term of a section 31T undertaking, the Panel can apply to the Court to enforce the undertaking. To date, the Panel has never had to apply for a section 31U enforcement order from the Court.

(1) Despite anything in the constitution of the target company, each director of the target company is entitled to have refunded to the director by the target company any expenses properly incurred by the director on behalf, and in the interests, of holders of equity securities of the target company in relation to an offer or a takeover notice that is made or given under the takeovers code.

(2) The target company may recover from the offeror any expenses properly incurred by the target company in relation to an offer or a takeover notice, whether as a result of refunds made under subsection (1) or otherwise.

31Z Panel may determine target company reimbursement claims

(1) The Panel may hold a meeting to consider an application for the reimbursement of the expenses referred to in section 31Y, after giving the target company and the offeror such written notice of the meeting as the Panel considers appropriate in the circumstances.

(2) Following the meeting, the Panel may determine the expenses that have been properly incurred by a target company in relation to an offer or a takeover notice, whether as a result of refunds made under section 31Y(1) or otherwise.

(3) If the Panel makes a determination under subsection (2), the Panel may make an order directing the offeror to pay to the target company the amount determined by the Panel.

(4) If the Panel makes an order under subsection (3), the Panel—

(a) must immediately give written notice to the person to whom the order is directed of the terms and conditions of the order; and

(b) may also give notice to any other person of those matters.

(5) An order made under subsection (3) may be made on any terms and conditions that the Panel thinks fit.

(6) The Panel may vary the order in the same way as it may be made under this section.

(7) The Panel may revoke the order or suspend the order on the terms and conditions it thinks fit.

31ZA Determination on the papers

If the target company and the offeror give their prior written consent, the Panel may hold the meeting under section 31Z without either of the target company or the offeror being heard or represented at the meeting.

31ZB Enforcement of reimbursement orders

(1) If the Panel has made an order under section 31Z(3), the target company may apply to the Court for an order under subsection (3).

(2) The target company may apply to the Court for an order under subsection (3) on the later of—

> *(a) 14 days after the Panel gave notice under section 31Z(4) of the Panel's order; or*
>
> *(b) the day after the date by which the Panel directed the offeror to pay the target company.*
>
> *(3) The Court may make any of the following orders if it is satisfied that the offeror has not complied with a term of the Panel's order:*
>
> *(a) an order directing the offeror to comply with that term;*
>
> *(b) any order that the Court thinks appropriate directing the offeror to compensate the target company or any other person who has suffered loss, injury or damage as a result of the failure to comply with the term of the Panel's order;*
>
> *(c) an order for any consequential relief that the Court thinks appropriate."*

46. The term "*offeror*" in these provisions should include *any person acting or who acted on the offeror's behalf, or any person acting or who acted jointly or in concert with the offeror.* This would deal with the situation where a special purpose vehicle was incorporated to make the takeover offer. The cost recovery mechanism for target companies would be undermined if liability for the costs could be avoided by the bid-vehicle being disestablished after a failed takeover.[23]

47. The proposal includes a provision for having hearings 'on the papers'. The idea behind this is to provide a lower cost approach to resolution of the dispute, provided both the target and the offeror agree on that approach. The Panel would also have a discretion regarding the use of this process. If the Panel decided that a physical hearing was necessary, so, for example, that the Panel could examine witnesses on oath, then it could decline to rely on the section 31ZA procedure.

Analysis of preferred option

48. It is clear from the judgment of MacKenzie J that rule 49 does not fit with the 'compliance with the Code' enforcement mechanism available under section 32 of the Act. Under the current enforcement provisions neither the Panel nor the Court can make appropriate orders to require an offeror to reimburse the target company for the properly incurred expenses that the offeror's offer (or proposed offer as signaled by a takeover notice) has imposed on the target company or its directors. Moreover, a reimbursement claim does not need to be dealt with under the very tight timeframes required by section 32 of the Act.

49. The preferred option would provide access to an effective and efficient dispute resolution process, adjudicated by the Panel as the relevant expert body. The process would be funded directly by the parties to the dispute (since an amendment to the

[23] Clause 9 of Schedule 1 of the Code does require the offer document to include confirmation by the offeror that it will have sufficient resources to meet not only the consideration it would have to pay if it gains full acceptances for the offer, but also to pay any debts that the offeror incurs in connection with the offer and under rule 49. However, this required statement may be insufficient, on its own, for dealing with a disestablished bid-vehicle.

Takeovers (Fees) Regulations 2001 would enable the Panel to recover its costs in determining the dispute), and could be dealt with expeditiously. The opportunity for hearings on the papers, if all of the parties (including the Panel) agreed to that approach, could result in a low cost and speedy adjudication process.

50. The Panel has already consulted the market, in 2008, on the enforcement of rule 49, and has published guidance on how it determines these disputes. Accordingly, the proposal could be fully operative as soon as the law is changed. The substantive issues have already been settled – only the process would be new. If it were thought necessary or useful, the Panel could publish guidance on how to make applications for a Panel order under the new provisions.

51. Because the proposal contains no ‘interest on unpaid amounts’ provisions, there would be no incentive for the target to be tardy in prosecuting its claim. To the extent that the Panel could apportion its costs to the target (for example, for unreasonably claiming for expenses that were not properly incurred) as well as to the offeror, the parties’ first likely approach should be to seek to settle the reimbursement figure between themselves. The Panel would be involved only where agreement could not be reached.

52. Under the proposal, the Court would have the flexibility to require a recalcitrant offeror to pay additional compensation to the target company or its directors. However, in order to keep the proceedings simple, efficient, and cost effective, the Court would not have the power to itself determine the substantive issues, i.e., the extent to which expenses were properly incurred by a target company and the reasonableness of the quantum of those expenses. Of course, any decision the Panel made under this process could be judicially reviewed.

53. The preferred option would fully achieve the policy objective of providing an efficient and effective mechanism for the resolution of rule 49 costs disputes. It could be readily implemented by the Panel. It would be completely self funded, requiring no additional Government funding for the Panel.[24]

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[24] This assertion about full self funding is dependent on the implementation of the current fees review of the Panel. Currently, the Panel is only able to recover approximately 60% of its costs, due to the level its fees are set at in the Takeovers (Fees) Regulations 2001.

PART TWO – QUESTIONS: A

1. What body do you think is most suitable for *assessing the categories of expenses* (as set out in *Code Word Number 24*) into which a target company's invoices would fall? The Panel? The Court? Some other person or body? Please explain the reasons for your answer.

2. Do you agree that the Panel is the appropriate *adjudicator* for rule 49 disputes? If not, please explain what body you think is most suited, and why.

3. Do you agree with the preferred option identified by the Panel? If not, please explain what your preferred option is, and why it would be better than the preferred option set out in this discussion paper.

4. If you agree with the preferred option, do you agree that the Panel should have a *discretion* to consider a reimbursement dispute (as indicated by the use of "*may*" in the opening words of the proposed section 31Z(1))? Please provide the reasons for your views on this.

5. Is the proposal to apply a broad definition of offeror, to include *any person acting or who acted on the offeror's behalf, or any person acting or who acted jointly or in concert with the offeror*, necessary or useful? Please explain the reasons for your views.

B: TECHNICAL ISSUE: THE DEFINITION OF CODE COMPANY

Problem identification

54. The Panel has recently become aware of an unintended consequence of an amendment made to the Takeovers Act and Code in 2006 that has the result of delaying the time at which certain companies become Code companies. According to both the Takeovers Act and the Code (as amended in 2006, as shown below by underlining), a company is a Code company if it:

    (a) is a party to a listing agreement with a registered exchange and has securities that confer voting rights quoted on the registered exchange's market; or

    (b) was within paragraph (a) at any time during a 12 month period prior to its involvement in a Code transaction or event; or

    (c) has 50 or more shareholders.[25]

55. Entering into a Listing Agreement with the NZX often precedes the undertaking of an initial public offering ("IPO") which, if successful, will result in many new shareholders entering the ownership of the company.

56. Prior to 2006, a company became a Code company at the time it entered into a Listing Agreement with NZX. Accordingly, the Code had to be complied with, or more usually, an exemption from compliance with the Code relied upon, in relation to an IPO itself if, as is sometimes the case, a shareholder proposed to take up a holding in the company, under the IPO, that would trigger the fundamental rule of the Code. The terms of the exemption would include that the offer documents clearly showed the potential control percentages of the person or persons, together with their associates, who would trigger the Code's 20% threshold as a result of the IPO.

57. However, in 2006 the definition of Code company was amended for the purposes of ensuring that debt-listed-only companies would not be caught by the Code.[26] Accordingly, the definition of Code company was changed, by adding the underlined words shown above.

58. At the same time, a new definition of "Q*uoted*" was also included in the Act, as follows:

    > "***Quoted****, in relation to securities of a person, means securities of the person that are approved for trading on a registered exchange's market...*"

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[25] The '50 or more shareholders' part of the definition is to be amended to '50 or more shareholders and 50 or more share parcels' under the *Regulatory Reform Omnibus Bill* which is expected to be introduced into the House in December 2010.

[26] Takeovers Amendment Act 2006. This was done because the Code is concerned with voting rights, but debt securities do not confer voting rights (as defined by the Code). As a result, the Panel was having to grant exemptions to remove such companies from the Code's ambit.

59. This new definition was intended to retain the timing at which a company became a Code company in advance of an IPO. It was thought that the words "*approved for trading*" in the definition linked the quotation to the timing of the entering into of the Listing Agreement.

60. Unfortunately, it has now become apparent that the 2006 amendments had the unintended consequence of altering the timing at which an equity-listed company becomes a Code company. The market, generally, has been unaware of the changed timing, as was the Panel until very recently,[27] when a market practitioner pointed out that the Code did not apply in respect of a proposed IPO, if the issuer entered into a Listing Agreement in advance of the IPO.

61. The Panel accepts that, as the Takeovers Act is drafted, an issuer's securities will not be "quoted" until the day stated in the NZX's Listing and Quotation Notice. Quotation, in practice, will usually be the first business day *after* completion of the allotments under the IPO. The words "approved for trading" in the definition of "quoted" appear to have no impact on retaining the original timing for becoming a Code company.

62. Consequently, it appears now that the Code need not be complied with until *after* the IPO (assuming that allotments to major shareholders are made before there are 50 shareholders on the share register).

63. This problem is not significant in terms of its frequency. There have been few IPOs in New Zealand since the global financial crisis in late 2008. Moreover, not all IPOs result in the Code's 20% threshold being triggered. As it transpired, the proposed IPO mentioned above turned out to be a matter not covered by the Code anyway. Accordingly, the problem has not yet had an impact on an IPO.

Policy objective

64. The policy objective for the proposal discussed below is the maintenance of investor confidence in the integrity of New Zealand's capital markets.

Options

<u>Option 1: Maintain the status quo</u>

65. The status quo reduces compliance costs for the promoters of IPOs because they no longer need to seek an exemption from compliance with the Code if a person, either alone or together with associates, could trigger the Code's 20% control threshold as a result of the IPO, and they no longer would have to make the disclosures in the disclosure document for the IPO that the conditions of such an exemption would require.

66. The flip side of this benefit to promoters is that potential investors under the IPO may have less information about the ownership structure of the company they are

[27] The Panel revoked a class exemption, that had been in place for IPOs, in 2007 (because it was being abused) – well after the 2006 amendments – and thereafter has granted individual exemptions for IPOs, the most recent of which was in 2008.

considering investing in. Perhaps more importantly, the Panel has no jurisdiction to monitor the IPO disclosures, nor to consider any complaints that investors might have about whether a person engaged in misleading or deceptive conduct in relation to the Code disclosures that would be required by the terms of an exemption.

67. Under the status quo, an inadvertent consequence of an amendment to the Code that occurred in 2006 has effected a policy change regarding the time at which a company becomes a Code company. That means that, at a time when the strengthening of the regulatory environment in New Zealand's securities and investments markets is being implemented, the law around the promotion of investment opportunities under an IPO has been reduced, without public consultation or parliamentary approval.

Preferred Option: Option 2: Amend Takeovers Act

68. The Panel's preferred option is to add to the definition of quoted, in section 2(1) of the Act, the underlined words shown below, as follows:

> "***Quoted****, in relation to securities of a person, means securities of the person that are approved, or in respect of which an application for approval has been made, for trading on a registered exchange's market…*"

Analysis of Preferred Option

69. Amending the Act in this way would restore the timing of becoming a Code company to the position it was in before the 2006 amendments to the Act inadvertently changed that position (even though it had not occurred to anyone until late 2010 that the position had changed at all).

70. The benefit of restoring the timing for becoming a Code company as a result of an IPO is that it would restore the Panel's jurisdiction to monitor and enforce clear disclosures about the potential ownership structure of the company (if a shareholder, or associated shareholders, trigger the Code's 20% threshold as a result of subscribing under the IPO).

71. Although the preferred option would reinstate the compliance costs for promoters of an IPO to the position they were in before the inadvertent change, it would align with the post-global financial crisis emphasis of better regulating the capital markets. The Minister of Commerce has advised the Panel of his expectation that the Panel's enforcement activities promote confidence and certainty in the markets.[28]

PART TWO – QUESTION: B

6. Do you agree with the preferred option identified by the Panel? If not, please explain what your preferred option is, and why it would be better than the preferred option set out in this discussion paper.

[28] Takeovers Panel Letter of Expectations 2011/12 from the Minister of Commerce.

APPENDIX A

GUIDANCE NOTE 12 – FRUSTRATING ACTION

APPENDIX B

(DRAFT) GUIDANCE NOTE – NEW RULES FOR OFFER CONDITIONS

APPENDIX C

CODE WORD NUMBER 24 – GUIDANCE NOTE:

RECOVERY OF EXPENSES UNDER RULE 49(2) OF THE CODE