

[DRAFT] GUIDANCE NOTE – NEW RULES FOR OFFER CONDITIONS

1. The Code is being amended to improve the regulation of conditions in offers. The new rules address an imbalance between the rules in the Code which regulate offer conditions and the prohibition in the Code against target companies engaging in defensive tactics to frustrate a takeover offer.
2. The new provisions of rule 25(1) of the Code provide:
 - 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.*
3. The changes to the Code by the introduction of these new rules are explained in this Guidance Note.

Rule 25(1) of the Code

4. 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.
5. The purpose of rule 25(1) is to promote certainty in takeover offers and prevent an offeror from circumventing the provision of the Code which prohibits an offeror from withdrawing an offer once it has been made.¹ Rule 25(1) achieves this by preventing the withdrawal of an offer at the offeror's discretion.
6. The purpose of rule 25(1) of the Code can be undermined if the offer includes conditions that are likely to be breached by the target company carrying on its ordinary business during the offer period. If an offer is subject to conditions of this nature, it is inevitable that the offer can only proceed if the offeror waives the restrictive conditions. This is inappropriate. A target company should be able to continue with its ordinary business during an offer period.
7. If the directors of the target company take action which could lead to a condition in an offer not being satisfied, the directors could be in breach of the Code's prohibition against defensive tactics. 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

¹ An offer may only be withdrawn with the consent of the Panel: rule 26(1) of the Code.

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.
8. The directors of the target company may be able to rely on one of the provisos to rule 38(1) contained in rule 39 of the Code. However, the provisos only protect the directors of the target company from non-compliance with the prohibition in rule 38(1). The action undertaken by the directors still gives rise to the offeror having the right to invoke or rely on a condition in its offer.

9. Rule 39 of the Code provides:

The directors of a Code company may take or permit the kind of action referred to in rule 38(1) if –

- (a) *the action has been approved by an ordinary resolution of the Code company; or*
- (b) *the action is taken or permitted under a contractual obligation entered into by the Code company, or in the implementation of proposals approved by the directors of the Code company, and the obligations were entered into, or the proposals were approved, before the Code company received the takeover notice or became aware that the offer was imminent; or*
- (c) *if paragraphs (a) or (b) do not apply, the action is taken or permitted for reasons unrelated to the offer with the prior approval of the Panel.*

New rule 25(1A) of the Code

10. The first new rule prohibits an offeror from including a condition in its offer which restricts the target company from carrying out its ordinary business activities. This applies during the offer period and the pre-offer period, from the sending of a takeover notice.
11. In May 2006, the Panel noted that it had seen offers which included conditions which restricted the business activities of the target during the offer period.² The Panel issued a Guidance Note which commented on the possibility that a condition could 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.
12. The Panel recognises that 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.
13. The new Rule 25(1A) effectively incorporates the Panel's 2006 guidance into the provisions of the Code itself.

² *Code Word (No. 16)*. Available online at <http://www.takeovers.govt.nz>, under Publications.

14. As the Panel noted in the May 2006 Guidance Note, there may be legitimate reasons for an offeror to include a condition in the offer which restricts the target company from engaging in some business activities during the pre-offer and offer periods. For example, an offer condition may restrict the target company from entering into a major transaction (as that term is defined in the Companies Act 1993). In many cases this condition is appropriate as it protects an offeror who, having made an offer for a company, finds that the company's business has changed significantly during the offer period. The new rule 25(1A) would not prevent an offeror from including such a condition in its offer because the condition does not purport to restrict the *ordinary* business activities of the target company.

New rule 25(1B) of the Code

15. The second new rule prohibits an offeror from unreasonably invoking or relying on a condition in its offer.

16. In determining whether it is reasonable for an offeror to invoke or rely on a condition in its offer, the Panel will likely consider:

- (a) Whether the condition is commercially critical to the offer. This would likely involve a consideration of the offeror's objectives in making the offer, together with a consideration of the nature of the target company's business;
- (b) Whether it appears that the offeror has a trivial or insignificant reason for invoking or relying on the condition;
- (c) Whether the offeror can waive the condition.

17. The purpose of the new rule is to facilitate the objective of rule 25(1) of the Code: i.e., to ensure there is certainty in takeover offers and to prevent the offeror from effectively holding an 'option' as to whether to proceed with its offer.

18. The new rule 25(1B) is likely to be relevant in cases where, for example, an offer contains conditions which seek to restrict the target company from entering into transactions outside of the ordinary course of business, such as the acquisition or disposition of assets, during the course of the offer period. Whether, under the new rule 25(1B), the offeror is entitled to rely on such a restrictive condition will depend on:

- (a) The extent to which the offeror had advance notice of the transaction being undertaken by the target company;
- (b) The significance of the transaction to the business affairs of the target company;
- (c) The progress of negotiations by the target company.

19. In considering any disputes about the application of the new rule 25(1B), the Panel is likely to try and balance the competing principles of ensuring there is certainty for the target company and its shareholders that, once made, a takeover offer will proceed, against ensuring that an offeror can still include conditions in the offer to protect its legitimate commercial interests

20. A target company which is undertaking a transaction that may trigger a restrictive condition should, when it receives notice of the takeover offer, consider the provisos to the prohibition on defensive tactics contained in rule 39 of the Code. The target company would be expected to obtain the approval of its shareholders under rule 39(a) for it undertaking the transaction.³ If the circumstances mean that obtaining the approval of shareholders is untenable, it may be appropriate for the Panel to grant consent to the directors' actions under rule 39(c) of the Code, on the grounds that none of other provisos in rule 39 apply and the action is taken for reasons unrelated to the takeover offer.

³ See the Panel's determination in relation to Otago Power Limited (29 May 2002) for more information about the Panel's expectations where the approval of shareholders is sought for the purposes of rule 39(a) of the Code (in particular, paragraphs 46 and following).