C/M/S/ Cameron McKenna

Directors' digest

Small bites on the big issues

July 2006

“Mittal ups the stakes in Arcelor bid battle”

“BAA directors in Ferrovial pledge”

Becoming a takeover target: should we recommend, fight, or negotiate?

In early discussions with the target board or its Chairman, the potential bidder will usually be trying to gauge the price it needs to pay to get its offer recommended. Although a bidder can always go hostile, and appeal to shareholders over the heads of management, most would prefer to see management recommend a deal to shareholders. Any takeover is risky, but advantages of a recommended offer include:

- acceptances are more certain, as most shareholders will follow the board’s recommendation to accept, and there is no restriction on the percentage of target’s share capital that the bidder can tie up, before the offer is made, by means of irrevocable undertakings from shareholders to accept the offer. By contrast, a hostile bidder cannot usually obtain undertakings over more than 29.9%
- a scheme of arrangement could be used to save the bidder stamp duty and increase its chances of acquiring 100%
- the bidder will usually be given access to non-public information about the target to do limited due diligence
- target employees may be more willing to co-operate with a bidder who is not labelled ‘hostile’, and directors are more likely to stay on to help manage the business.

Quid pro quo for a recommendation

Bidders are therefore usually prepared to pay a higher price to obtain a recommendation. Apart from negotiating the price, the target board may also be in a position to influence the type of consideration and the terms offered to holders of convertibles and options. For example, where the target has lots of individual shareholders, they may want the bidder to provide a loan note alternative. In the recent Ferrovial/BAA deal, BAA shareholders were also offered the opportunity to take shares (as well as loan notes) in a specially-established AIM company with a minority interest in the merged company.

In return, the bidder may demand a period of exclusivity, a ‘break fee’ payable by target if the directors withdraw their recommendation (or in other circumstances) and/or a merger agreement governing how bidder and target will conduct the offer process.

To recommend or not?

All of these matters can raise difficult issues for target directors. Their obligation to act in the best interests of the target (broadly meaning those of its current shareholders) does not mean that they must recommend the highest bid, or indeed any offer, but they will need good reasons to reject an offer made at a fair price. In last year’s takeover of Manchester United by the Glazer family, having failed to obtain assurances from the bidder that the levels of debt to be borne by the club would not compromise investment in new players or drive up ticket prices, the club’s directors refused to recommend the final offer but had to acknowledge that the price was fair and that, given that the Glazers had already bought enough shares in the market to give them control, it would be financially prudent for shareholders to accept.

Quote of the quarter

“The proposed obligation on directors actually to have regard to the interests of employees… customers, the …environment and the desirability of the company maintaining a reputation for high standards of business conduct… [is] no threat to the practical running of companies in the UK. Of the company directors I see, those worth their salt already have regard to all of these factors and more.”

(David Chivers QC, commenting on the controversial directors’ duties clause in the Company Law Reform Bill in a letter to the Financial Times on 11 May)

Defensive tactics

If a bidder is really unwelcome, the alternatives for target directors are limited. In the UK, it is generally felt that shareholders should be free to decide on the ownership of a company, and that boards should not deprive shareholders of the opportunity to consider the merits of an offer. Once the target board believes that a bona fide offer might be imminent, actions that might ‘frustrate’ a bid – such as issuing shares to friendly parties, selling key assets or entering into unusual, onerous contracts – cannot be taken without shareholder approval. Had Arcelor been a UK company attempting to ward off Mittal Steel’s bid by selling a large minority stake to the Russian company, Severstal, the sale would have required approval by a simple majority of all the ordinary shareholders. Where the UK differs from some continental jurisdictions and US states is in the difficulty of lawfully putting in place before any bid has materialised ‘poison pill’ and other ‘change of control’ provisions that are designed to deter a bidder or prevent control of the company passing to outsiders. Unless such an arrangement can be justified on other commercial grounds, a director who approves it could breach his duties to act in the best interests of the company and to exercise his powers for a proper purpose, and the arrangement itself may be void. For example, including a ‘golden parachute’ clause in a director’s service contract, giving him a substantial lump sum payment if the company is taken over, may not be proper unless it is genuinely needed to recruit, retain or motivate the director. It would also probably attract criticism from shareholders.

Market raids: a shift in the balance of power?

Political lobbying, involving regulators, and seeking a ‘white knight’ bidder are all common, but efforts in the UK are mostly focussed on good old-fashioned argument. However, with the abolition in May of the Substantial Acquisitions Rules, target directors and their shareholders will more often find themselves presented with a bidder who has already bought nearly 30% of the company. Argument and discussions over any recommendation can then be a mere formality.

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In the pipeline

Company Law Reform Bill

A 23-strong standing committee of the House of Commons currently has the task of scrutinising the 900-odd clauses and 16 schedules of the Bill over 44 hours between now and 13 July. Ignoring the schedules, the present timetable allows about three minutes per clause or, perhaps more realistically, about 5-10 minutes per tabled amendment. Many of the issues will have been debated already by the House of Lords.

Meanwhile, the Government is consulting on another 400 or so clauses that are intended to copy across clauses from the existing legislation to create a single consolidated new Companies Act. Although the consolidation process is not intended to change the law, inevitably there will be some restructuring and consequential amendments, and the Government will need to persuade the opposition parties that this process has not resulted in inadvertent changes or unforeseen consequences. The Government hopes to table the consolidation clauses by 13 July and ask the standing committee to go on to review them. Before it becomes law, the whole Bill will then have to go through the report stage in the Commons.

The Bill as a whole is expected to receive Royal Assent before the end of the year. However, partly because various secondary legislation and model articles will need to be drafted and consulted upon, and partly because Companies House will need time to conform their procedures and forms to the new legislation, most parts of the Bill are unlikely to come into force until 6 April 2007 or – perhaps marginally more likely - 1 October 2007.

Directors' toolkit

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Q&A

Indemnities for directors

In April last year, in recognition of increasing concern about directors' exposure to claims brought by investors, creditors, regulators and other third parties, the restrictions on companies indemnifying their directors, and lending them money to fund their defence costs, were significantly relaxed. But because the new rules are quite complex, and taking advantage of them often requires specific documents to be drafted, and company articles to be amended, take-up has been fairly slow, particularly amongst non-listed companies.

What can I be indemnified against?

Any UK company can now indemnify any of its directors, and any director of a company in the same group, against damages, costs and interest awarded against him in civil proceedings brought by a third party, and against legal and other costs incurred in defending both civil and criminal proceedings if and when the director wins or is acquitted, or the claim is settled or dropped. But an indemnity cannot cover fines or penalties (as this would be contrary to public policy), nor can it cover damages etc for a director's negligence or breach of fiduciary duty towards his own company or another group company (as this would compromise director accountability).

Can I insist on being given an indemnity?

No. The changes are merely permissive, so boards must decide whether, and to what extent, any particular director should be indemnified. Amongst other things, boards should consider the size of possible claims compared to the company's assets; whether the company's liability should be capped; how an indemnity should dovetail with any D & O policy; and generally whether an indemnity is in the company's best interests. However, it is becoming quite common for companies which do business or have securities listed in the US to grant wide-ranging indemnities to directors who may be exposed to class actions and other claims.

What about loans to fund defence costs?

In practice, this could be at least as important, particularly where there is a risk that any D & O cover could be exhausted before a case has even reached trial. Companies can now agree to advance funds to a director to meet any defence costs in civil or criminal proceedings on an 'as incurred' basis. All advances are repayable, but if the director wins or is acquitted, or the claim is settled or dropped, the company can in principle agree to waive repayment. As with an indemnity, the board will need to decide on a case-by-case basis whether and on what terms to make such a loan.

My company's articles of association say that directors "shall be indemnified" – is this sufficient?

Although such wording may appear to provide an indemnity, or to instruct the board to put indemnity arrangements in place, case law indicates that, because directors (in their capacity as such) are not 'parties' to the articles, such wording does not give them an enforceable right against the company. A director therefore needs either a service contract which expressly incorporates this part of the articles or a stand-alone indemnity agreement.

What if I'm the company's representative on the board of a non-group company, such as a 50:50 joint venture?

Although the issue is not free from doubt, the statutory rules probably do not restrict the scope of indemnity that your company can give you. However, it is all the more important that any indemnity can be justified as being in the best interests of your company. Also, an indemnity for fines or penalties is unlikely to be valid.

What about overseas companies?

Clearly, the above rules on indemnities and loans to directors only apply to UK companies. For an overseas company, its local law will dictate whether and on what terms it can provide an indemnity or loan to its own directors or to directors of another company. But the UK rules do not appear to restrict the type of indemnity that a UK company can provide to a director of an overseas group member, such as a US subsidiary.

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Directors' toolkit

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