London's scheming

The UK Takeover Panel takes a flexible approach to schemes of arrangement

The scheme of arrangement is the structure of choice in the UK's buoyant M&A market, in part because of the sizable tax savings available. Liquidity, funded by private equity and debt markets, is high and many public bids are becoming competitive. This has implications for the mechanisms the Panel on Takeovers and Mergers has in place for the resolution of competitive situations.

In April 2007 Tata Steel acquired Corus Group by way of a scheme of arrangement. It was a competitive bid, culminating in a Panel auction to resolve a competitive process.

Schemes of arrangement

Six of the last seven largest takeovers of UK targets involved schemes of arrangement: Scottish Power (£11.6 billion), Alliance Boots (£10.6 billion), Reuters Group (£8.6 billion), Gallaher (£7.5 billion), Corus (£6.2 billion) and Hanson (£6 billion). The Panel has always retained flexibility in applying the Takeover Code to schemes due to the more complicated procedure and timetable for effecting takeovers by way of scheme.

The Takeover Panel's current consultation paper (PCP 2007/1) is designed to codify the application of the Code in a number of ways and to distinguish, where necessary, between schemes of arrangement and contractual offers.

The increasing popularity of schemes in effecting the largest transactions is a reflection of the market's acceptance that the advantages now outweigh the disadvantages, in part due to the development of Panel and court practice in recent years.

The view of the scheme of arrangement as the current transaction structure of choice contrasts starkly with the provision for schemes in the Code. This was recognized in 2005, when Panel Practice Statement 14 was issued to give guidance on how the Executive would apply the Code to schemes.

The use of schemes of arrangement, their potential for further development and the implications of this for the Code are particularly of interest when considered in the context of a competitive situation. The recent acquisition of Corus by Tata Steel was, as is recognized in PCP 2007/1, the first example of two competing offerors seeking to use schemes of arrangement to make an acquisition. Typically, if one offeror has already made its offer by way of scheme and its scheme document is in court, when a rival offeror makes an approach, it will announce that it intends to proceed by way of an offer, but will reserve the right to switch to a scheme of arrangement. In the contested acquisition of Corus, when a second offeror (CSN Acquisitions) emerged, it too sought to carry out its offer for Corus by way of scheme.

However, the court had already granted permission to Corus to begin the Tata Steel scheme of arrangement. So CSN announced that it would proceed by way of a pre-conditional scheme. One of the pre-conditions of the CSN scheme was that the Tata Steel scheme was withdrawn from court or was rejected by Corus shareholders at a general meeting before the CSN scheme began. This pre-condition was capable of waiver by CSN.

One of the consequences of this approach was that (in the context of a competitive takeover) the Tata Steel offer had a timetable advantage as it could deliver consideration monies to Corus shareholders faster than the competing CSN scheme. If the Tata Steel scheme had to be withdrawn before the CSN scheme could be submitted to court, all of the preliminary steps for proceeding with a scheme (submitting a claim form, attending a hearing for directions and submitting a draft scheme to court) would have to be repeated.

In a competitive situation, the time value of money calculation by target shareholders can be important, particularly if shareholders seek to arbitrage between share price and offer price.

In any competitive situation, the ability of rival offerors to increase the price they offer to target shareholders and to vary the terms on which that offer is made is critical. The choice of a scheme to effect a takeover has historically been seen as restrictive, but in the context of the offers for Corus, Tata Steel increased its original offer and both Tata Steel and CSN Acquisitions participated in an auction process regulated by the Panel, during which a number of increased offers were made for Corus.

Before the takeover of Corus, there had been a limited number of examples of schemes of arrangement being varied to increase the price offered to target shareholders, these included the takeovers of Associated British Ports and P&O. Since the auction for Corus, revisions were made to the scheme to acquire Countrywide and there were changes to the schemes to acquire John Laing.

PCP 2007/1 addresses the issue of the use of schemes of arrangement in competitive situations in the context of Rule 32.5 and the timetable implications for offerors. It suggests that revisions to a scheme of arrangement (including as to price) should normally not be made less than 14 days before the date set for the EGM and court meeting, so that target shareholders have enough time to consider the revised terms. However, if shareholders have had the relevant scheme circular for at least 21 days and so are therefore only being asked to consider an increased price, a 14-day period should not be required.

PCP 2007/1 also addresses schemes announced in competition with contractual offers, contractual offers announced in competition with schemes, and schemes announced in competition with schemes. In the latter case, the Panel highlights the recent acquisition of Corus by Tata Steel and the use of competing

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schemes by Tata Steel and CSN Acquisitions. It highlights this case as a good example of why the Panel needs to retain discretion and flexibility in competitive situations.

This example does acknowledge the possibility of competing schemes of arrangement, but it does so in the context of the later scheme being pre-conditional upon the withdrawal of the first. It is interesting to consider the possibility of competing schemes of arrangement that do not contain such a pre-condition.

There are two principal structures that could, in theory, be used for competing offers made by way of scheme of arrangement. They are characterized below as parallel schemes and dual-option schemes.

The concept of two offerors being party to the same scheme is not entirely untested. In 1998, when Vickers sought to dispose of Rolls-Royce Motors it agreed a sale with BMW conditional upon shareholder approval and the approval of a scheme of arrangement to restructure the group's capital. Shortly afterwards, Vickers received a higher offer from Volkswagen for Rolls-Royce Motors, but to avoid breaching its agreement with BMW, it was forced to put the original offer to Vickers shareholders for approval. To approve the scheme, two EGMs were held, the first to consider the disposal to BMW and the second to consider the disposal to Volkswagen. Consequently, the scheme document contained two options for the restructuring, depending on which disposal the Vickers shareholders approved.

Unsurprisingly the Vickers shareholders approved the sale to Volkswagen, but the possibility of using a scheme of arrangement structured in this way (a dual-option scheme) offers a number of potential benefits in competitive situations.

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Dual-option schemes

When CSN Acquisitions sought to proceed by way of scheme when Tata Steel already had its scheme in court, CSN Acquisitions was at a timetable disadvantage. Had a scheme circular been sent to Corus shareholders containing both options (that is, the Tata Steel scheme and the CSN Acquisitions scheme) the two parties would have been on a more equal footing in the competitive process.

Exactly when a competitive situation arises might be critical in determining whether a dual-option scheme can be used. The Panel will usually require that an offer document or a scheme circular be posted to target shareholders within 28 days of a firm intention to make an offer being announced. If a rival offeror does not emerge until towards the end of this period, the Panel might feel that it is in the best interests of target shareholders to receive the scheme circular from the target in connection with the first offer rather than to delay it so that the target can produce a hybrid scheme circular containing dual options. In these circumstances, there is no reason why, if a second offeror subsequently announces a firm intention to make an offer and wishes to proceed by way of scheme, that a dual-option scheme cannot be introduced at that stage. The scheme circular would reproduce the details of the first circular, but would incorporate details of the second offer and would fix a single date for the two EGMs and a court meeting. The target would also have to make an application to court to amend the scheme to provide for the dual option.

This approach is arguably clearer for target shareholders, because they receive a single document from the company setting out both options. This contrasts with what happened in the Tata/Corus case when, after receiving a scheme circular from Corus, shareholders then received an information document from CSN. This was an unattractive route for a rival bidder, which had secured a board recommendation, to use to communicate with target shareholders (being more akin to the approach taken by a bidder in a hostile takeover).

In addition to providing greater clarity to shareholders, use of a dual-option scheme should align, to a greater degree, the court timetable for a scheme with the timetable imposed by the Panel in competitive situations. It might be that greater involvement of the Panel with the court process on a scheme will be required if the proposed codification of the treatment of schemes in the Code is to be successful.

If companies do wish to use dual-option schemes (particularly if there is a prospect that announcement of a public offer from one party will elicit rival offers), the terms of any proposed implementation agreement, the scheme itself and the scheme circular should be carefully considered by target companies to ensure that they do not unduly restrict their options if a rival bidder does emerge.

Parallel schemes

A second potential structure for competing schemes of arrangement is the use of parallel schemes. This approach might be more suitable in circumstances where much time has passed between the announcement of rival offers, or if there is a preference for describing the rival offers to shareholders in separate circulars.

Under this structure, the first scheme of arrangement might have been introduced to court in advance of a rival bidder emerging and a scheme circular might already have been posted to target shareholders. After the announcement of a rival offer and before posting a second scheme circular, the target company would have to approach the court to seek permission for a second scheme.

There is a potential risk in the parallel scheme approach that, if the second offer is approved by target shareholders, when a judge in the High Court is asked to bless that scheme, he may take the view that the use of parallel schemes is an abuse of court process and might refuse to approve the scheme. Provided that the target makes this process clear and it is blessed from day one the risk that this would be seen as an abuse of process by the court would be low, particularly given the increased flexibility the court has shown in recent years in its treatment of schemes of arrangement. But any parallel schemes should be structured in a way that ensures the court can only ever be asked to approve one of the two.

Once a rival scheme is also in court, a second scheme circular could be posted and the timetable of the first offer would be reset to that of the second offer. The EGMs for each offer could be held in series and the notice of the subsequent court meeting could contain both options.

Adjournment

In a competitive process where one or more of the parties is seeking to proceed by way of scheme of arrangement, the target board might, for a number of reasons, decide that it is in the best interests of its shareholders to adjourn the EGM and court meeting convened to consider the proposed scheme.

Tata Steel and Corus forged their merger in the fires of competition

"The Panel's ability to adopt other procedures allows competitive situations to be resolved outside a prescriptive formula"

On Tata Steel's acquisition of Corus, the Corus board adjourned meetings to consider the Tata Steel scheme twice. Once because, after the announcement of its pre-conditional interest by CSN Acquisitions, the Corus board wanted to give CSN Acquisitions enough time to conduct due diligence. The second time, there had been an increased offer from Tata Steel and a firm intention to make an offer announced by CSN Acquisitions and it was expected that the Panel would shortly announce a Rule 32.5 process so the meetings were adjourned *sine die*. There is debate over whether a target should seek approval from the court before adjourning the court meeting. In 2006, P&O did not seek court approval when adjourning its court meeting and it was highlighted that the court or dissident shareholders could have objected to this. Corus did not seek court approval for adjournments and faced no challenge, whereas John Laing sought (and received) court approval for both the adjournment and reconvening of its court meetings. The Panel has now indicated in PCP 2007/1 that it should be consulted in advance if a target proposes to adjourn its court meeting.

Resolving competitive situations

The Takeover Panel was first asked to look at a situation where competing offers remained open and capable of revision on Day 46 in 1983 when offers were made for Eagle Star Holdings. But the issue did not come before the Panel again for almost 15 years, when in 1998 rival offers for the Energy Group remained open on Day 46. In both cases the proposed Panel auction procedure, using sealed bids, was never used. In the Energy Group case, the Panel allowed formula bids in the sealed bid process, a concept that was challenged by one of the bidders.

The Panel subsequently consulted on the topic in 2001 and following that consultation amended the Code to introduce Rule 32.5, which formally provides for the Panel to publish auction procedures on an *ad hoc* basis to resolve competitive situations.

Since then, the Panel has used its powers under Rule 32.5 on a number of occasions.

- In 2003 the Panel established a public auction for the acquisition of Debenhams. A four-day open auction was provided for, with a final sealed bid round on day five. Formula bids were not permitted. This procedure was never used.
- In 2004 the Panel established a public auction procedure for the acquisition of Canary Wharf. A three-day open auction was provided for and both bidders revised their offers on each day and made public announcements to that effect. Formula bids were not permitted.
- In 2005 the Panel again used a three-day public auction procedure for the acquisition of QXL Ricardo. Again formula bids were not permitted.

Earlier this year, the Panel made a departure from its post-Rule 32.5 approach to competitive situations by reverting to a sealed bid process to resolve the acquisition of Corus. The Panel auction held at the end of January this year also marked the return of formula bids.

The goal of any sealed bid auction is to replicate as closely as possible a sequence of offers in a short timeframe so that finality is achieved and the best price payable by the auction participants is found.

The auction for Corus was held over eight rounds of fixed price bidding, which commenced on January 30 2007 at 16:30, once the markets had closed. During the auction neither party was permitted to acquire target shares or to make any announcement (this included communications with market participants). One hour was permitted for each round and the party with the lower bid in the previous round was required to make a higher bid (by a minimum of 5 pence above the previous higher bid) in the next round for the auction to proceed. As both parties remained in the auction until round eight, the use of a final formula bid round was required in which each party had to submit a bid stating an increment above the rival bidder's price that it was willing to pay up to a maximum amount.

After the formula bid round, the Panel informed each bidder and Corus of the final bids and, in the early hours, announced the amount of both bids on newswire services. Each bidder was then required to make an announcement of its revised offer.

These differing approaches reflect the various competing principles that the Panel seeks to give effect to when implementing Rule 32.5. The Panel aims to provide an orderly framework within which a competitive situation can be resolved and to achieve finality within a reasonable period, while the target board seeks to secure the best possible price for its shareholders.

Rule 32.5 gives the Panel the option to set a mechanism in place to achieve finality with only limited extension of the timetable beyond Day 46, which also helps to achieve the best price for target shareholders. The flexibility in the Code and the Panel's ability to adopt other procedures agreed by the parties is helpful as it allows competitive situations to be resolved outside a prescriptive formula. Without agreement between the parties on how to resolve a competitive situation, the Panel will follow the process set out in Rule 32.5 and the accompanying notes, and will seek to follow the principles described in its consultation paper (PCP 7). However, a number of challenges exist to concluding existing auctions regardless of whether an open auction or sealed bid process is adopted.

Preparing for the auction

The Panel will only invoke its powers under

Rule 32.5 to achieve finality when it appears that a genuine competitive situation will be ongoing on Day 46. The Panel has recently refused requests on behalf of targets for an auction process to be used before Day 46 (for example, John Laing). One reason for this is that there can be a big impact on target and offeror share prices when an auction is announced. Negotiating the auction rules with the Panel is a detailed process given the competing interests of the target and rival offerors, and this process will begin well before Day 46. Although the Panel will announce a summary of the auction process, the auction rules are kept confidential.

Cash confirmation

The cash confirmation process is a main element of preparation for any auction (it is now being seen in larger private auctions too) and should be in place and confirmed before the auction begins. Because any bidder will have to be cash-confirmed up to the maximum price it is willing to pay at auction, there needs to be a degree of flexibility within the financing structure because not all of the facilities might be required if the bid is successful.

Offer comparison

In any situation in which both offerors are not making all-cash offers for the target it is difficult to envisage a sealed bid process being used by the Panel. Issues of valuation would be likely to preclude the inclusion of a requirement that bids were raised by any minimum increment and the interaction of an all-cash offer with a mixed cash and securities offer might also preclude the possibility of formula bids being permitted. On this basis, it is more likely that a public auction process similar to the Canary Wharf approach would be adopted. However, this approach could subject the target and offerors to scrutiny and risk an unnecessary degree of volatility in their respective share prices, as the process cannot be concluded in a single out-of-hours session.

Market operations

Increasingly, bidders are acquiring a blocking stake in the market to secure their target (or at least to ensure that no one else does). Often in a competitive situation a bidder acquires a large share in the market immediately before announcing or revising its offer as a means of delivering a knockout blow to rivals.

A number of considerations need to be taken into account if this strategy is adopted but, when a bidder is using a scheme of arrangement any shares acquired in the market cannot be voted on the scheme and will not count in the total. A market operation could have the effect of concentrating the influence of the rival's stake in the target and increase its ability to block a scheme. The Panel is also proposing to codify the rules on when connected exempt principal traders may vote shares on a scheme.

Another point to consider is the use of market purchases after an auction. Given the time value of money, immediately after the resolution of an auction, the share price of a target will typically settle at a discount to the offer price (the level of the discount will be determined by the length of time from completion of the auction until investors think they will receive consideration for their target shares). After an auction, neither bidder will be able to acquire shares in the market above its final offer price. This allows for the possibility that (if the difference between the winning and losing bids is small enough) the loser in an auction could conduct a market operation after the auction and acquire a blocking stake in the target at below its best offer price.

Equal offers

After an auction process using sealed bids, if both offers are the same, a draw would raise a number of market issues. The interests of finality dictate that additional delay should not be permitted, but the target board is likely to want to allow each bidder a final opportunity to raise its offer. Participants in any auction should consider what might happen in the event of equal offers and how the auction might be designed to prevent them.

> **"A market operation could concentrate the influence of the rival's stake in the target and increase its ability to block a scheme"**

Withdrawal

A losing bidder in an auction is likely to be required to announce its (lower) offer and not be permitted to withdraw that offer until after the winning offeror has gone wholly unconditional or has reached the scheme effective date.

The time this takes can vary, but there is a risk that a losing bidder will have to keep a cash-confirmed offer open for a number of months after an auction and incur substantial financing costs as a result. This might also inhibit its ability to proceed with other acquisitions in the short term.

Flexibility needed

The increased use of schemes of arrangement is a feature of the UK M&A landscape and the Panel is correct to propose amendments to the Code to reflect this. Given the increasingly competitive M&A market, it might not be long before truly competitive schemes emerge and the Panel makes further use of its Rule 32.5 powers.

The Panel must retain flexibility in its application of Rule 32.5 to ensure that the differing positions of targets and bidders can be accommodated on a case-by-case basis.

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