THE TAKEOVER PANEL

PROPOSED OFFER BY WM LOW AND CO PLC FOR BUDGENS PLC

The issue

The Panel met on 26 June to consider whether, in announcing an offer for Budgens plc ("Budgens"), Wm Low and Co PLC {"Wm Low") and its financial adviser, S G Warburg & Co Ltd ("S G Warburg"), acted in breach of General Principle 3 of the Code, which states that an offeror should only announce an offer after the most careful and responsible consideration.

The recommended offer was announced on 20 April 1989. It was conditional among other things on the approval of Wm Low shareholders. On 12 May 1989, a joint announcement was made to the effect that, since the directors of Wm Low had indicated that they would not be able to recommend their shareholders to approve the offer, the offer was, with the agreement of Budgens and the Panel, being withdrawn. The announcement stated that "differences in expectations about the financing for the combined group have become apparent in the course of preparation of the offer documents".

The Panel Executive subsequently investigated the situation. This investigation involved considering in detail with the parties, whose accounts were in some respects divergent, the entire history of their dealings prior to the announcement of the offer. Wm Low and S G Warburg were also given an opportunity to make representations. The Executive concluded, in the light of its enquiries, that disciplinary proceedings should be commenced against Wm Low and S G Warburg. The Panel, therefore, had to consider whether, in view of the importance which Wm Low attached to the future financial position of Budgens when it actually emerged, it and its financial adviser, S G Warburg, had exercised

"due diligence" in investigating the position prior to the announcement of the offer. This required a careful analysis of the dealings between the parties.

Summary of events

Wm Low and Budgens are companies of similar size, both engaged in the retail business. The suggestion that the businesses might be brought together through the acquisition of Budgens by Wm Low was considered by Wm Low over the course of the seven weeks from the beginning of March 1989. During this time, Mr James Millar, chief executive of Wm Low, met Mr John Fletcher, chairman and chief executive of Budgens, three times, on 7 and 21 March and on 12 April. No one else was present at any of these meetings. The advisers of the parties did not then meet. Wm Low was regularly consulting S G Warburg, but Mr Fletcher of Budgens had decided not to instruct Kleinwort Benson Ltd ("KB") until the discussions reached a later stage.

For the purpose of its evaluation, Wm Low constructed a computer model to produce projected profit and loss accounts through to 1991, as well as cash flow statements for the same period. Mr Millar informed us that this model was prepared in large part on the basis of Wm Low's own evaluation of the business of Budgens, but the assumptions on which it was based and the principal conclusions reached were put to Mr Fletcher for confirmation. This basis was adopted because from the outset Mr Fletcher, for various reasons, was unwilling to provide any information.

Wm Low confirmed to Budgens on 17 April that it wished to proceed with the proposed offer. A negotiating meeting was arranged for 19 April. Budgens then informed KB of the proposal. Negotiations took place until early on 20 April. The parties agreed that the offer would be of 37 new Wm Low shares for every 60 Budgens shares held which, assuming full acceptance of the offer, would have left Budgens shareholders holding approximately 49% of the enlarged issued share capital of Wm Low. There was,

however, also to be an underwritten cash alternative equivalent to £9.25 for every 6 Budgens shares. The offer valued each Budgens share at £1.78. The cash alternative amounted to £1.54 per share.

As a result of the production of working capital statements during the process of preparing the offer document, information about Budgens was made available to Wm Low which caused the board of Wm Low to reconsider whether it could recommend the offer to its own shareholders. Although Wm Low sought to renegotiate the terms of its offer, its revised proposals were unacceptable to Budgens. Accordingly, Wm Low concluded that it would not be able to recommend its shareholders to approve the offer. In these circumstances, Budgens accepted that no useful purpose would be served by requiring that the offer document be posted. S G Warburg had consulted the Executive as to Wm Low's obligations under the Code at various stages and, in the light of this decision of Budgens, Wm Low was permitted by the Executive not to proceed. In giving this permission, the Executive was reflecting the fact that no useful purpose would be served by refusing to do so; it was not in any way expressing a view as to the financial position of Budgens. The Executive had made it plain, during discussions as to the withdrawal of the offer, that it would have to conduct an enquiry into the events leading up to the announcement of the offer and to investigate, in particular, whether there had been compliance with General Principle 3.

The withdrawal of the offer naturally caused concern and some shareholders voiced anxiety to the Executive.

Whilst there was substantial agreement between Wm Low and Budgens as to most of the facts we have so far stated, there was disagreement between them as to the exact purpose and status of the discussions between Mr Millar and Mr Fletcher prior to the negotiations on 19 April, and as to the precise details of the information provided. The resolution of such disagreement would not, in the view of the Panel, have assisted us to determine the central question with which we are concerned. We believe that

the essential issue is whether, in the light of the importance clearly attached to Budgens' profitability and levels of borrowing, Wm Low and S G Warburg should have pressed Budgens for further information.

We therefore approach the issue on the assumption that the facts were wholly as stated by Wm Low and S G Warburg. We also accept the contention of S G Warburg that we should not proceed on the basis that the mere existence of some conflict of evidence indicated the importance of Wm Low seeking confirmation of the information which it was given orally. It would not be just to adopt such an approach without hearing extensive oral evidence on the matters in issue.

Wm Low and S G Warburg represented to us that the level of current and contemplated borrowings and its effect upon future profitability was a matter of central importance in reaching its decision not to proceed with the offer. Accordingly, it is necessary to examine the information regarding the level of borrowings and future profitability which Wm Low obtained from Budgens prior to announcing its offer.

The most recent published audited accounts of Budgens were for the period to 31 December 1987, since when its business has changed very significantly. Budgens has changed its year end to 30 April. Consequently, at the time Wm Low was considering making its offer, Budgens was coming to the end of a 16 month accounting period. It had issued two six monthly interim statements of profits in respect of parts of that period. No balance sheet as of a date later than 31 December 1987 had been published, but a statement of indebtedness as at 26 September 1988 was contained in a class 1 circular dated 12 October 1988.

Because Mr Fletcher was unwilling to provide information about Budgens, Mr Millar said that Wm Low would produce a computer model of Budgens and then seek confirmation from Mr Fletcher as to the accuracy of the assumptions made and principal conclusions

reached. Wm Low proposed thus to build up, with the assistance of S G Warburg, a picture of the merged group and proceeded to do so.

At the hearing Wm Low informed the Panel that it had received indications as to Budgens' future profitability in meetings held during March and April. Wm Low also had access to various brokers' circulars relating to Budgens against which it was able to compare its own conclusions. Neither Wm Low nor S G Warburg requested a formal profit forecast.

The extent of the borrowings of Budgens does not appear to have been discussed between Mr Millar and Mr Fletcher at their meeting on 7 March. On 21 March, however, Mr Millar recollects that he informed Mr Fletcher of the level of borrowings as at December 1988 assumed in the Wm Low computer model and Mr Fletcher said that the actual borrowings had been higher and gave a figure. At the same meeting, according to Mr Millar, Mr Fletcher also indicated the level of capital expenditure, and its basic timetable, which he envisaged in the coming financial year. The December 1988 borrowing figure given by Mr Fletcher was thereafter used in the computer model. Wm Low used its own estimates of anticipated capital expenditure because that would be within the control of Wm Low following the merger. Budgens and its advisers have subsequently informed the Panel Executive that December 1988 borrowings were in fact slightly lower than Mr Fletcher indicated.

There was no discussion of borrowings at the meeting on 12 April and, until 19 April, it does not appear that any enquiry was made as to what borrowings would be at the end of April 1989. It is agreed, however, that on 19 April Mr Fletcher gave an estimate of the anticipated profitability, of the then current Budgens borrowings and of the expected level of borrowings at the year end (30 April). This new information was not built in to the Wm Low computer model.

The director of S G Warburg with day to day responsibility for the case informed us that, on 18 April, he requested a Budgens balance sheet and this request was repeated on 19 April. However, no balance sheet was provided. No explanation was sought by or given to Wm Low or S G Warburg as to why it had not been forthcoming.

It appears from this evidence that Wm Low did not seek or obtain from Budgens any specific estimate of anticipated future borrowings nor ascertain which part of the future capital expenditure was already committed. It was not until the subsequent working capital review that any details were given as to future borrowings. There appears to have been no enquiry into Budgens' own estimates of its future borrowing requirements but it seems clear that when the extent of the anticipated future borrowing of Budgens was disclosed in the working capital review, it was seen as of importance to Wm Low.

The duty of potential offerors and their advisers under the Code

General Principle 3 states that:

> "An offeror should only announce an offer after the most careful and responsible consideration. Such an announcement should be made only when the offeror has every reason to believe that it can and will continue to be able to implement the offer: responsibility in this connection also rests on the financial adviser to the offeror."

Compliance with this principle is of great importance. The announcement of an offer inevitably has a profound effect upon the market. The share price of the offeree company will be affected and, in consequence, if the offer is subsequently withdrawn - for whatever reason - many people may have dealt on the basis of expectations which are not fulfilled. Against this background, General Principle 3 attempts to reduce to a minimum the number of offers which are withdrawn by placing upon potential offerors and their advisers an obligation to exercise due care before making an offer. This Code duty is of a standard similar to that which the law imposes upon professional

people or indeed anyone who purports to possess some special skill. It is a duty to display that standard of skill and care which would ordinarily be expected of someone exercising or professing to exercise the particular skill in question. The Panel stresses that General Principle 3 is designed to protect shareholders of the offeree company and those who might deal or consider dealing in the shares of the offeree company. Accordingly, to the extent that it is practically possible to exercise care, the Code duty arising under General Principle 3 cannot, as S G Warburg accepted, be limited simply to setting out the conditions to which a particular offer is subject.

The practical content of the Code duty to exercise appropriate care will inevitably depend upon all the circumstances of the case. Where there is a unilateral offer, it may be very difficult for the offeror to obtain reliable detailed information concerning the business of the offeree company. The issue of what is reasonable in each case turns in part upon the likely reaction of the offeror to unanticipated developments or revelations following the announcement of an offer. If, for example, a very large company were proposing to take over a small company just to obtain a particular product, it might be perfectly reasonable for it not to investigate the profitability or borrowings of the target, because subsequent revelations relating to those aspects of the target's business would not be relevant to the offeror. But, on the other hand, in the case of a proposed merger of companies of similar size, the offeror is likely to be much more sensitive to the precise financial position of the offeree. In such a situation, which existed in the present case, it is necessary for the offeror, where it has the opportunity to do so, to take greater care to investigate that position in advance.

In saying this, the Panel is conscious that at all times directors who are inviting their shareholders to vote on the issue of whether or not to support an offer must give their advice in the light of their continuing fiduciary duty to the company. This means that, in the event of a fundamental change

of circumstances, it may be necessary for them to change the view which they conscientiously held at the time of the announcement of the offer. In its 1974 annual report, the Panel made clear that where resolutions from offeror shareholders are necessary, the Panel does not take the view that the directors of the offeror are obliged to recommend shareholders to vote in favour of the offer in all circumstances. But it was stressed that directors are not free to ignore what they have done in the name of the company. Since failure to proceed is a very serious matter, the directors must bear this in mind in making their recommendation. It equally follows that, in order to do all they can to avoid a situation arising where they may ultimately recommend their shareholders to vote against an offer which they have announced, the company and its advisers have to meet a high standard in fulfilling the obligation to exercise care.

The submissions of the parties

The Executive submitted to the Panel that the conduct of Wm Low and S G Warburg breached General Principle 3. In reply, Wm Low and S G Warburg made full written and oral submissions to the Panel and these were considered in detail.

The Panel's decision

The essential issue which we had to consider was whether, in all the circumstances, Wm Low and S G Warburg should, before deciding to make an offer, have sought more information. In particular, we had to consider whether they should have sought further clarification of the future borrowing position and thus the likely interest charge for 1989/90. We also had to consider whether they should have pressed for an up to date balance sheet and a 1989/90 budget.

We have already said that the standards of care to be observed with regard to General Principle 3 are high but that they must depend upon the nature of the particular negotiation and the extent to which a particular factor or state of affairs is critical to the position of the offeror. Hindsight must be avoided but when an offer is announced and the offeror then withdraws in consequence of the production of certain information, the question inevitably arises whether the offeror ought to have foreseen that the relevant information might lead to a reconsideration of the offer and have sought that information at an earlier stage. The Panel does not consider that it is always necessary to seek an up to date balance sheet and budget or written confirmation of all the information provided by the offeree. In some circumstances, for example, oral information from the offeree's financial adviser would be adequate. We thus had to consider what was necessary in the circumstances of this case. In doing so we were conscious of the need to avoid judging with the benefit of hindsight and of the high standard of proof needed in disciplinary cases of this kind.

In the present case the Panel recognised that Wm Low and S G Warburg carried out a considerable amount of work in seeking to discharge the obligation to exercise the appropriate degree of care. It is also noted that Mr Millar and his colleagues spent a considerable amount of time visiting stores and forming their own view as to the prospects of the business. In a contested situation, this might very well have been all that was possible. But in this case the parties were in regular contact and proceeding towards a recommended offer. It is relevant that whilst Mr Millar and Wm Low had throughout sought the advice of S G Warburg at all stages, it was known that on the other side there had been no involvement of Budgens' advisers. Mr Fletcher alone had been conducting discussions on behalf of Budgens.

Wm Low and S G Warburg relied on their computer model and did not request a balance sheet until the day before the meeting of 19 April. They did not at any earlier time request a copy of a December 1988 balance sheet and they had not sought to obtain before 19 April details of the current level of borrowings, nor did they seek estimates of future anticipated borrowings or ascertain what part of the capital expenditure was actually committed. The Executive submitted that the process of the production of the computer model, however carefully conducted, could not compensate for these deficiencies. We accept that future capital expenditure, and hence to a certain extent future borrowings, would have been within the control of Wm Low had the merger proceeded. However, the Wm Low model related in part to the period before the proposed merger. The borrowings which Budgens might have made, and capital expenditure it might have actually committed, before April 1989, were, therefore, important in establishing the opening position of the merged company and likely future trends of indebtedness. When Wm Low and S G Warburg learnt on 19 April that the actual level of borrowings as at April 1989 was significantly higher than Wm Low had expected, doubts ought to have been raised as to the reliability of the picture emerging from the model.

In all these circumstances, we consider that S G Warburg ought to have asked Budgens for some more detailed explanation of the position as to current and future borrowings. It is clear that the working capital requirements of Budgens were a critical element in the decision as to whether or not to proceed on the announced terms, as was demonstrated by the subsequent withdrawal. In the light of the fact that they were so important, we consider that S G Warburg should have pressed harder for a balance sheet which was up to date and for a budget for 1989/90. A balance sheet would have put the extent of borrowings in the context of the other relevant items, such as creditors. The more important the information is to the decision, the greater the steps that should be taken to obtain certainty before the offer is announced.

We do not know what the responses would have been to a request for such a balance sheet and budget nor even to an oral request for further information as to future borrowings. We bear in mind that, in the light of the movement of the share price of Budgens, Wm Low felt that they had to reach a decision speedily. They equally may have felt that Budgens might demur from supplying any such written information. But, if Budgens had demurred, and if its reasons had been unconvincing, that itself would have been a factor in any decision as to whether or not to proceed.

We therefore conclude that there was a breach of the standards of care in the present case and accordingly a breach of General Principle 3 by the offeror's side.

We do not think, however, that Wm Low can itself be criticised for this breach. It is clear from the way he gave evidence before us that Mr Millar sought conscientiously to discharge his responsibility in every way. He held three meetings with Mr Fletcher. He consulted his board at every stage. He consulted S G Warburg before every meeting. We consider the responsibility for the breach lies with S G Warburg. It is they who, on behalf of their client, should, prior to any announcement of an offer, have been requiring or at the very least pressing hard for essential information, namely further details of borrowings, a budget and an up to date balance sheet.

The withdrawal of a bid after its announcement is a most undesirable step, which should not normally be considered except in the most extreme circumstances. It follows that, before announcing an offer, the directors of the offeror and its financial advisers should take all reasonable steps to satisfy themselves that, where the offer is made subject to the consent of the offeror's shareholders, they will remain able to recommend the offer to those shareholders. This involves diligently endeavouring to obtain all relevant information which might be

available so as to reduce to a minimum the risk that, after the announcement of the offer, information will be discovered which causes the directors and advisers to change their minds.

The Panel decision set out above was the subject of an appeal by Wm Low and S G Warburg to the Appeal Committee of the Panel. The Appeal Committee (The Right Honourable The Lord Roskill, Chairman, Mr G G Williams and Mr E H Bond) heard the appeal on 28 July 1989 and unanimously dismissed it. Certain amendments which the Appeal Committee required to be made have been incorporated in this statement. Those amendments do not affect the substance of the decision.

1 August 1989