

THE TAKEOVER PANEL

DE ZOETE & BEVAN LIMITED ("BZW")

PURCHASES OF SHARES IN NORTHERN ELECTRIC PLC ("NORTHERN")

On 18 December 1996, two days before the final closing date of the offer made for Northern by CE Electric UK Plc ("CE"), Northern's financial advisers, J Henry Schroder & Co Limited ("Schroders"), and its stockbrokers, BZW, separately contacted the Panel Executive. Each wished to buy Northern shares as principal. On the basis of established precedent and relying on certain information and assurances given by both BZW and Schroders and described in more detail below, the Executive permitted such purchases to take place subject to immediate public disclosure under Rule 8. BZW and Schroders subsequently purchased shares, BZW acquiring 1.63% of Northern's issued share capital at a total cost of approximately £10.7 million.

CE considered that such purchases constituted "frustrating action" in contravention of the Code, in particular General Principle 7 and Rule 21. At CE's request, a Panel hearing was convened and held later on the same day. Rejecting CE's complaint, the Panel held for the reasons set out in Panel Statement 1996/17 that there had been no breach of the Code.

However, as a result of further information provided to the Executive by BZW on 20 December, it transpired that the decisions of the Executive and the Panel on 18 December had been taken without the knowledge that there was a "performance" element in BZW's fee arrangements payable at the discretion of the Northern Board, which discretion was exercised only on 19 December. In the light of this new

information, the Panel decided at a further hearing on 20 December to extend the final closing date for CE's offer to 1.00pm on 24 December, a decision subsequently upheld by the Appeal Committee.

On 23 December the Executive announced that it was conducting an investigation into the circumstances in which information, possibly having a bearing on certain purchases of Northern shares, was received from BZW only subsequent to consultation with the Executive and the hearing before the Panel on 18 December. The principal issue addressed in the course of the investigation was the reason why BZW did not disclose its performance fee as a relevant fact either to the Executive or to the Panel on 18 December.

This investigation has now been completed. The Executive remains of the view that the Northern Board had not been aware of the decision by its advisers to purchase Northern shares beforehand nor, as a matter of fact, had it been influenced by such purchases when deciding to pay the performance fee subsequently. The Executive also believes that there was no deliberate concealment of the performance fee by BZW. However, BZW accepts that it ought to have considered the existence of its performance fee to be relevant to the deliberations of the Executive and the Panel on 18 December. BZW is criticised for failing to disclose all relevant facts.

Background

During the early stages of CE's offer, BZW negotiated a fee arrangement with Northern which included two elements. The main element was a fee to be determined in accordance with a sliding scale dependent on the highest offer price for Northern shares. On the basis of the value of CE's final offer, the main element of the fee crystallised at £1.5 million. The second element was a performance fee of up to £250,000 payable at the discretion of Northern prior to any offer becoming unconditional as to acceptances. On 13 December BZW submitted separate invoices in respect of both fee elements. Schroders' fee arrangement included no performance fee.

BZW and Schroders first briefly discussed purchasing Northern shares as principals during the course of the week commencing 9 December. On 16 December BZW considered an internal paper which referred to the possibility of using £0.5 million of its fees to make share purchases and considered the downside risk of the proposal "compared to our fee of £1.5 to £1.75 m". This paper also referred to the perceived need to take legal advice on the performance fee as to whether "contrary to the facts, it might be considered an inducement".

At the suggestion of Schroders, Norton Rose were retained on 16 December by both itself and BZW to advise in relation to their proposal. BZW separately telephoned Norton Rose and described its fee arrangements, including the performance fee, explaining that when the fees were being negotiated share purchases were not in contemplation and that the performance fee had no connection whatsoever with any share purchases. BZW also said that it thought that it had already earned its performance fee, by virtue of its advice and efforts to date. Shortly thereafter, Norton Rose advised, inter alia, that they did not think that the payment of this additional performance fee would be construed as financial assistance under Section 151 Companies Act 1985, as the purpose of paying the fee was not linked to acquiring the shares but to BZW's general performance in the conduct of the defence. Norton Rose also advised BZW that before making any purchases the Panel should be consulted generally.

On 17 December the prospect of making purchases of Northern shares receded. Late that afternoon, BZW had a brief conversation with the Chairman of Northern on the question of fees, reminding him that payment had to take place before the bid became unconditional and suggesting that this could happen at any time. As a result of this conversation, BZW formed the impression that it would receive the proposed fees in full. However, BZW was not aware that the Northern Board had, in fact, decided the previous evening to postpone the decision on whether to exercise its discretion to pay the performance fee until nearer the close of the bid.

On 18 December a bid for London Electricity plc was announced which, in the opinion of Northern's advisers, served to highlight the inadequacy of CE's bid and to

increase the likelihood of defeating the bid by making share purchases. BZW decided that it was prepared to make much more significant share purchases (up to a value of £19.7 million) than it had previously contemplated. At a meeting early that morning at BZW's offices, Norton Rose confirmed its previous advice that the purchases would not constitute insider dealing and that, reinforcing BZW's own belief, the performance fee was not an inducement. At about 9.00am, BZW and Norton Rose telephoned the Executive to inform it that BZW was considering making purchases of Northern shares as principal, independent of Northern and without its knowledge. The Executive was told that any such purchases would be made entirely separately from the exempt market-maker and it was possible that Schroders might also participate.

Having considered the matter, the Executive telephoned back to say that it would be permissible for BZW to purchase Northern shares subject, inter alia, to there being no inducements or indemnities with regard to such purchases. BZW was also requested to confirm that there would be no adjustment to its fee as a result of such purchases. BZW gave such confirmations, but did not refer to its performance fee. Schroders separately contacted the Executive by telephone. Similar confirmations were sought and received by the Executive from Schroders.

Shortly thereafter, purchases of Northern shares were made by BZW and Schroders. Northern was informed about them for the first time by its advisers later that morning. CE's advisers complained to the Executive that the purchases constituted "frustrating action" and indicated that it wished to appeal the Executive's decision to the Panel. Accordingly, the Executive imposed an immediate ban on further purchases, subject to the outcome of the Panel hearing which was arranged at exceptionally short notice that evening. Given the limited time available and with the consent of the parties, the Executive alone provided a paper which set out the relevant facts and CE's objections to the Executive's ruling. In order to present this paper as fully and accurately as possible, the Executive consulted each of the parties that afternoon. As well as reconfirming with both BZW and Schroders that their fee arrangements were not contingent on the outcome of the offer, the Executive agreed with each adviser that it

was appropriate to describe the fee arrangements in the paper for the Panel hearing as "flat".

The Executive's paper was sent to each of the parties, including the Panel, and was seen by BZW when it arrived at a meeting at Schroders' offices shortly before the hearing. The paper, comprising seven paragraphs, included the following statements:

"Schroders and BZW sought and obtained permission from the Executive to make purchases in Northern shares on the basis that such purchases were conducted on an arm's-length basis with no financial support, arrangement or understanding of any kind with Northern, that there would be no fee payable to them by Northern in respect of such purchases and there would be no change in the flat fee basis of their remuneration under the offer generally. In other words, Schroders and BZW would bear the full economic risk of purchasing and holding such shares."

"CE's advisers have argued that the purchases constituted "frustrating action" in the broadest sense and are offensive to the spirit of the Code as well as General Principle 7. They argue that it is obvious that the motivation for these purchases is to frustrate the bid and that Northern's advisers have a financial incentive in trying to preserve the independence of their client in the expectation of future fee income, regardless of whether there are any actual financial inducements from Northern to encourage them to do so at the present time."

At the outset of the hearing on 18 December, the Director General invited the parties to correct any errors or omissions in the Executive's paper. He also said that the Executive had consented to Schroders and BZW purchasing Northern shares as principals, "that is to say without any financial support or inducement from their client, Northern". He then continued "although Northern's advisers may wish to comment on this, I believe that not only are the fee arrangements unaffected by these purchases, but also I believe that there are flat fee arrangements in this bid, in other

words there is no difference in their remuneration, depending upon whether the offer succeeds or fails". BZW made no comment on this.

During his oral submission, a representative of Schroders said on behalf of both Schroders and BZW, "I think it is important for me to confirm to you all that the company had no prior knowledge of these purchases prior to us operating in the market this morning. There is no financial incentive in our fee arrangements. They are the same whether the bid succeeds or fails. It is important for you to know that and there was no influence from the company encouraging us in the actions that we took". BZW said nothing at all about the fee arrangements and were asked no direct questions about them.

Relying, inter alia, upon the above and in ignorance of BZW's performance fee, CE's advisers sought to argue that, amongst other things, notwithstanding that BZW and Schroders "clearly do not expect to benefit in economic terms", they had been induced to purchase Northern shares by the prospect of future fees payable by a "happy client" who would continue to retain them if the bid lapsed.

The appeal was held without any knowledge on the part of the Executive, the Panel or CE's advisers of BZW's performance fee. On the basis of the information presented to it, the Panel dismissed the appeal.

On the evening of 19 December BZW contacted the Executive by telephone and requested a meeting. BZW said that it was about the phraseology in Panel Statement 1996/17, which had referred to the flat fee basis of BZW's remuneration. At the meeting with the Executive at about 8.15am on 20 December, BZW explained the arrangements for its £250,000 performance fee and handed over a copy of its engagement letter dated 27 November. BZW said that it wished to be completely clear about what the Panel meant by the words "flat fee basis" in its Statement, although BZW thought that this was appropriate wording as there was no success fee and no fee contingent on the share purchases or on the outcome of the bid. BZW also referred to the brief conversation on 17 December with the Chairman of Northern which led it to believe that the full fees of £1.75 million would be payable. The

Executive indicated that it wished to speak to the Chairman of Northern as soon as possible and that it would revert to BZW. BZW obtained the Executive's permission to continue buying shares in the meantime, although no further purchases were in fact subsequently made either by BZW or Schroders.

When the Executive was able to contact the Chairman of Northern, it discovered that Northern's Board Committee had not decided to pay BZW the performance fee until the previous day, 19 December. The Chairman confirmed that, in exercising its discretion, the Board Committee had had regard solely to BZW's performance as an adviser and had disregarded the share purchases. The Executive had no reason then or subsequently, in the light of its investigation, to doubt this. However, as it had emerged that the decision to pay the performance fee had been taken only after the shares had been purchased, the Executive forthwith requested that payment of the performance fee be suspended, although it remained content for BZW to make further share purchases if it so desired.

Subsequently, the Executive ruled that the performance fee should not be paid but that the share purchases could stand. BZW has informed the Executive that it did not seek to challenge this ruling as it considered that to do so would not be in the interests of its client at that stage of the bid. However, CE appealed on the basis that it considered the Code to have been breached. That appeal was heard during the evening of 20 December. The Panel's decision, upheld by the Appeal Committee, to extend the deadline for acceptances to CE's offer was the subject of Panel Statement 1996/20.

The investigation announced by the Executive on 23 December has now been completed. In the course of this investigation, BZW informed the Executive that the performance fee had not been considered relevant for disclosure to the Executive or to the Panel on 18 December because, amongst other reasons:

- BZW believed that the performance fee had been earned on the basis of its performance as an adviser prior to making any share purchases and believed that this had been recognised by the Chairman of Northern;

- the performance fee arrangement had been entered into well in advance of any consideration of the possibility of making share purchases and, in BZW's opinion, Northern could not, in agreeing to it, have intended or expected it to act as an inducement to buy shares;
- it had obtained advice from Norton Rose on 16 December, subsequently confirmed on 18 December, that the performance fee was not an inducement;
- BZW considered that the performance fee of £250,000 could not commercially or objectively be regarded as an inducement to purchase up to 3 million Northern shares at a total cost of up to £19.7 million and that BZW was not in fact influenced by the prospect of receiving the fee;
- on 18 December BZW understood the words "flat fee" when used by the Executive and the Panel to mean only that its fees were not dependent on the success or failure of the bid; and
- BZW did not realise that the performance fee might be relevant under the Code.

Code Issues

Paragraph 3(b) of the Introduction to the Code contains the following statements:

"When there is any doubt whatsoever as to whether a proposed course of conduct is in accordance with the General Principles or the Rules, parties or their advisers should consult the Executive in advance. In this way, the parties can obtain clarification of the basis on which they can properly proceed and thus minimise the risk of taking action which might, in the event, be a breach of the Code.

Both principals and their advisers are encouraged to make full use of this service. To take legal, or other professional, advice on the interpretation or

application of the Code is not an appropriate alternative to obtaining a view or ruling from the Executive."

Furthermore, it is a well established feature of the way in which the Code operates that the Executive and the Panel are entitled to expect full disclosure from those who are involved in its work and appear before it. In clearing a course of action with the Executive, there is therefore an onus on the party concerned to make full and proper disclosure of any fact which might be relevant.

The Executive's findings

BZW had recognised that (although in its view contrary to the fact) the performance fee might be capable of being considered an inducement to purchase shares in Northern and thus could raise legal issues. BZW obtained legal advice reinforcing its own view that the performance fee was not in fact an inducement. BZW knew or ought to have known that this advice, and its own belief, could not be relied upon as a substitute for raising with the Executive the question as to whether the performance fee was an inducement for the purposes of the Code.

BZW confirmed in response to the Executive's questions on 18 December that there was no inducement. It did not disclose the existence of the performance fee during the Panel hearing later that day, even though the main issue at that hearing was whether there was any financial incentive, inducement or arrangement emanating from Northern in relation to the share purchases constituting "frustrating action".

The Executive believes that there was no deliberate concealment of the performance fee by BZW. However, BZW accepts that it ought to have considered the existence of its performance fee to be relevant to the deliberations of the Executive and the Panel on 18 December. BZW is criticised for failing to disclose all relevant facts.

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