The City of London Law Society

The Law Society

PCP 2023/1 Review of Rule 21 (restrictions on frustrating action) and other matters

21 July 2023

Introduction

1. The views set out in this response have been prepared by a Joint Working Party of the Company Law Committees of the City of London Law Society (**CLLS**) and the Law Society of England and Wales (the **Law Society**).

2. The CLLS represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

3. The Law Society is the professional body for solicitors in England and Wales, representing over 170,000 registered legal practitioners. It represents the profession to Parliament, Government and regulatory bodies in both the domestic and European arena and has a public interest in the reform of the law.

4. The Joint Working Party is made up of senior and specialist corporate lawyers from both the CLLS and the Law Society who have a particular focus on issues relating to takeovers.

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Response

5. We agree that a review of the frustrating action rules is timely and appropriate. As noted in the PCP, offer timetables have become increasingly protracted and, as a result, R21.1 therefore has greater potential to impact target companies, and inhibit their ability to carry on "business as usual", for extended periods. In this context, and in any event, the proposed recalibration of R21.1 to exclude "ordinary course" transactions is particularly welcome.

6. We also support the separate response to the PCP that we understand is being submitted by the Share Plan Lawyers Group.

Q1 Should the new definition of "restricted action" be introduced in the new Rule 21.1(c) as proposed?

7. We do not have any comments on the proposed new definition.

Q2 Should issuing shares or convertible securities, granting options or awards over shares, or redeeming or buying back shares or convertible securities by the offeree company, other than in the ordinary course of business, in any amount be a restricted action, as proposed in the new Rules 21.1(c)(i) to (iii)?

8. We agree with this proposal.

Q3 Should the current Note 5 on Rule 21.1 be amended as proposed with regard to employee incentivisation arrangements?

9. Yes. As the PCP notes, it is common for target company boards to seek to grant options/awards in the ordinary course. As such, where this is consistent with normal practice it should be permitted as is the case under current R21.1.

10. We also welcome the proposed approach in relation to grant of options/awards under new incentive schemes. In circumstances where the proposed practice under the new scheme has not been publicly disclosed before the start of the relevant period, it would be helpful to understand whether the Panel may still treat the grant of options/awards as ordinary course where this is consistent with the target company's past practice under prior schemes and/or divergence from past practice is to address changes in applicable law or best practice.

11. It would be helpful to understand how the Panel would approach a situation where there has been board approval of an option grant before the start of the relevant period but no further action has been taken. In circumstances where the subsequent award decision would not (for some reason) fall within new N1, would the Panel consider the action to have been partly implemented and therefore permitted under R21.1(e)(v)? We note that paragraph 6.3 of draft PS34 would suggest that a board decision would normally be insufficient, but we would question whether the same analysis should apply in the context of share awards.

12. We understand the Panel's intention behind these amendments is not to reduce Panel submissions in this area (paragraph 2.15 of the PCP) as it would still expect a target company to consult in order to confirm its intended actions were ordinary course. Instead, the PCP notes that the intention is that the amendments will reduce the need for the target company to notify or seek the views of the bidder as part of the process. In practice, we suggest these proposals are unlikely to reduce the need for target companies and bidders to engage with each other about planned share plan grants and settlements, as the bidder needs to understand (in great detail and in real time) the value and nature of all outstanding share incentive interests to (a) price its offer (b) seek required cash confirmations and (c) formulate its appropriate proposals. If the intention is that target companies would consult the Panel to confirm actions are ordinary course, we suggest this could be made clearer in R21.1(d). At present, the natural reading is that if the target company believes its actions are ordinary course, there is no need to consult the Panel (or the bidder).

13. We also had the following points in relation to the drafting of new N1:

- We would suggest that that the word "employee" is removed from the title of the Note and where it appears in N1(c) as these provisions should extend to non-executive directors and other workers (e.g. consultants) that are not strictly employees.

- We would also suggest that N1(a)(i) and (ii) refer to incentive schemes (rather than share incentive schemes) to make it clear that it covers incentive structures other than options, LTIPs etc – for example, annual bonus plans which require bonus deferral into shares.

- Under N1(b), it would be helpful to understand that the delivering of market purchase shares (and the funding of such purchases, for example via a contribution to an employee benefit trust) would similarly be considered ordinary course. It would also be helpful to understand how the Panel would approach a situation where a prospective or new-joiner employee has been promised (in writing) a one-off share plan grant in connection with their recruitment. Such arrangement may or may not have already been approved by the target company board. Would the Panel consider the action to have been partly implemented and therefore permitted under R21.1(e)(v)? Or would the Panel take a generous view of the target company's ordinary course activities in this context?

- Under N1(c), it would be helpful to understand who the Panel considers to be "senior management". Would this be, for example, any direct reports of the CEO or Chair?

Q4 Should a redemption or purchase of its own shares by the offeree company in line with defined limits announced or established before the relevant period normally be in the ordinary course of the offeree company's business, as proposed in the new Note 2 on Rule 21.1?

14. We agree with this proposal and with the Panel's view that a normal buyback programme would not usually be likely to frustrate an offer.

15. We note that the proposed new N2 on R21.1 refers to defined limits "announced or established" before the relevant period. It would be helpful to understand when the Panel would consider defined limits to have been "established" for these purposes – is this referring to the circumstances set out in paragraph 2.42 of the PCP or would the Panel consider other factors when determining whether defined limits have been established? How would the Panel approach a position where the target company has announced an intention to return cash to shareholders via a combination of dividend and buyback but not formally launched the programme (and, potentially, not confirmed the maximum amount to be returned)?

Q5 Should the Panel be able to have regard to additional or alternative indicators of materiality that it considers appropriate either in the context of the relevant industry or in order to take into

account the particular circumstances of the offeree company when determining whether a disposal or acquisition of assets is of a material amount, as set out in the proposed new Note 3(c) on Rule 21.1?

16. We agree with this proposal.

17. We note that N3(d) refers to assets with a value of less than 10% also having the potential to be considered material if they "are of particular significance". In this context, it would be helpful to understand whether significance would be assessed by reference to the target company or the bidder (this could usefully be made clear in the note).

18. As a more general point, we note that the FCA is currently consulting on (amongst other changes) removal of the profits test from the Listing Rules class tests. Whilst we appreciate the Listing Rules are a separate regime, it would be helpful to understand whether the Panel may revisit N3(a)(iii) if the FCA adopts its changes as proposed.

Q6 Should only disposals and acquisitions that are outside the ordinary course of the offeree company's business be included in the calculation when determining if the relevant assets are, in aggregate, of a material amount, as set out in the proposed new Note 3(e) on Rule 21.1?

19. We agree with this proposal.

Q7 Do you have any comments on the matters that the Executive will consider when determining whether a disposal or acquisition of assets is in the ordinary course of the offeree company's business, as set out in the draft new Practice Statement No 34?

20. If a company has announced (or publicly trailed) a strategy that involves, for example, exiting a territory or disposing of a division or assets that should not automatically (as seems to be implied by draft PS34) be treated as outside the ordinary course.

21. In relation to the cumulative effect of acquisitions and disposals, we note that paragraph 2.5 of draft PS34 envisages that a further acquisition/disposal will be considered outside the ordinary course but will only be treated as "restricted action" if it is material. But paragraph 2.4 seems to envisage that any transaction could be relevant if, overall, the level is outside the ordinary course. If only material transactions would be caught, ignoring paragraph 2.4, that could usefully be made clear.

Q8 Should the Panel normally consider an inducement fee arrangement proposed to be entered into by the offeree company to be a material contract outside the ordinary course of the offeree company's business if: (a) before a firm offer is announced, the fee is more than 1% of the market value of the equity share capital of the offeree company (as determined in accordance with the new Note 3 on Rule 21.1); or (b) following the announcement of a firm offer, the fee is more than 1% of the value of the offeree company by reference to the offer price (as is currently the case)?

22. We agree with this proposal.

Q9 Do you have any comments on the matters that the Executive will consider when determining whether: (a) an individual contract; or (b) a particular type of contract, is in the ordinary course of the offeree company's business, as set out in the draft new Practice Statement No 34?

23. We note that paragraph 2.76 of the PCP and paragraph 3.2 of draft PS34 refer to the Panel applying "a low threshold" when determining whether a contract is material – it would be helpful if the Panel could provide further guidance on this if possible.

24. In relation to the extension of R21.1(c)(v) to amending material contracts, it would be helpful if the Panel could confirm that a minor amendment to a material contract would not constitute restricted action.

25. It would be helpful to understand whether the Panel considers that the guidance in paragraphs 3.2 and 3.3 of draft PS34 would also apply for the purposes of the requirement to disclose material contracts under R24.3(a)(vii) or whether the guidance should be treated as specific to the application of R21.1.

26. We agree that settlement agreements should normally be regarded as ordinary course, reflecting the

principle that the board should be in a position to achieve the best outcome for shareholders. We assume one of the factors to be taken into account would be advice received from legal counsel.

27. We note that PS34 covers settlement agreements in relation to commercial disputes. However, we assume that compromise agreements entered into with departing directors, employees etc. would also be capable of constituting ordinary course transactions (in particular given the ability to make ex gratia payments in such a context will, in any event, typically be limited by the target company's remuneration policy etc.).

Q10 Should the Panel be consulted to determine whether entering into offer-related employee retention arrangements that relate to a period that is prior to the end of the offer period would be a restricted action, as proposed in the new Note 1(c) on Rule 21.1?

28. We agree that consultation is appropriate – however, we note that N1(c) requires consultation regardless of materiality and that it provides that the Panel may treat arrangements as restricted action where they are significant in value or relate to directors/senior management. Presumably, in practice, the Panel would be unlikely to treat arrangements involving directors/senior management as restricted action if they were not significant in value terms (in particular where they involve cash)?

29. It would also be helpful to understand how the Panel would approach the position where arrangements relate to a period that is partially before and partially after the end of the offer period (for example, retention arrangements may be structured to pay out in 12 months' time, irrespective of when the offer completes; or alternatively, (if earlier) three months following completion of the offer).

Q11 Do you have any comments on the circumstances in which the Executive may consider entering into offer-related employee retention arrangements to be a restricted action, as set out in the draft new Practice Statement No 34?

30. We do not have any comments.

31. However, it is currently common practice for target company and bidder to agree that a certain amount of money (i.e. an unallocated cash bonus pool) can be used by the target company in its discretion for cash-based retention (with the bidder agreeing it would not regard use of cash up to the agreed amount to be frustrating action). It would be helpful to understand the Panel's perspective on approval of an unallocated cash bonus pool, given the factors in paragraphs 5.3(b) - (f) would be unlikely to be known.

Q12 Should: (a) the current Note 3 on Rule 21.1 (Interim dividends); and (b) the current Note 6 on Rule 21.1 (Pension schemes), be deleted?

32. We agree with these proposals – however, please see below in relation to reverse takeovers.

Q13 Should the restrictions in Rule 21.1(a) apply during the "relevant period", as specified in the proposed new Rule 21.1(b)?

33. We agree with this proposal.

Q14 Where no offer period has begun, should the relevant period end at 5.00 pm on the seventh calendar day following the date on which the latest approach is unequivocally rejected?

34. We agree that an extension is appropriate and do not have any objections to the period of seven calendar days.

35. PS32 currently provides that R21.1 will "normally" continue to apply until 5pm on the second business day following unequivocal rejection and that the Panel "must be consulted" where the target company intends to take any action falling within R21.1 following an unequivocal rejection. We note that new R21.1(b) is phrased in more binary terms, and we wonder whether including drafting along similar lines to PS32 may be helpful in providing a degree of flexibility to the Panel in appropriate circumstances.

Q15 Should the new Note 7 on Rule 21.1 be introduced as proposed to clarify the application of the relevant period where there is more than one offeror?

36. It would be helpful to understand how the Panel would interpret the reference to "a proposal with indicative terms" and what this would encompass/what level of specificity would be required. On the face of the wording, it would appear to be a much higher threshold than making an approach. We agree with the analysis set out in paragraphs 3.23 and 3.24 of the PCP that R21.1 should not be engaged at an early stage, but where a potential bidder has demonstrated a willingness to engage more fully in relation to making a potential offer (for example by stating it was considering making a proposal within a range or at a premium and by committing resource/incurring cost by engaging in the due diligence process), it felt to us that (on balance) the frustrating action rules should be engaged even if the potential bidder has not, at that stage, proposed an indicative price.

Q16 Should the new Note 9(a) on Rule 21.1 be introduced to provide that, where the offeree board is seeking a potential offeror for the company, the relevant period for a potential offeror will not normally begin until that potential offeror makes a proposal with indicative offer terms?

37. We agree with this proposal.

Q17 Should the new Note 9(b) on Rule 21.1 be introduced to provide that, where a purchaser is being sought for interests in shares carrying in aggregate 30% or more of the voting rights of a company, the Panel should be consulted to determine when the relevant period will begin?

38. We agree with this proposal.

Q18 Should presumption (7) of the definition of "acting in concert" be amended to provide that the directors of a company that is subject to an offer or a possible offer (together with their close relatives and the related trusts of any of them) are presumed to be acting in concert with each other from the beginning of the relevant period or, where the proposed new Note 9 on Rule 21.1 applies, the beginning of the offer period?

39. We agree with this proposal.

40. We note that the proposed amendment to the first sentence of N3 on R9.1 narrows its scope to target company directors only. This results in there being no detail in N3 on R9.1 on the position of bidder directors in an offer period.

Q19 Should the new Note 8 on Rule 21.1 be introduced as proposed to provide that where an offer or possible offer is a reverse takeover, Rule 21.1 will also apply to the board of the offeror as if the offeror were an offeree company and vice versa?

41. We agree with this principle, however it would be helpful to understand whether the Panel would envisage applying the rules differently in relation to certain actions taken by the bidder in a reverse takeover scenario.

42. For example, in relation to dividends we would note that the reasons for removing the restriction in respect of target company dividends (i.e. ability for the bidder to adjust the offer price) do not apply in relation to dividends paid by the bidder. We also note that the bidder would not be permitted to agree any contractual restrictions on dividend payments in the context of a reverse takeover given the prohibition on offer-related arrangements would also bite on it. It would be helpful to understand how the Panel might approach applying the frustrating action rules to dividends paid by the bidder in a reverse takeover scenario, in our view as an exception to the general principle the target company should be permitted to seek an undertaking from the bidder in relation to the permitted level of dividend payments by the bidder.

43. Share buy-backs are another area where it would be helpful to understand the Panel's approach in a reverse takeover scenario.

44. In terms of when the R21 restrictions would bite on the bidder in the context of a reverse, we assume that (consistent with new N7) this would be the time of that bidder making an approach or (if earlier) when that bidder is publicly identified in an announcement. It would be helpful if the Panel could confirm that our understanding is correct.

Q20 Should: (a) the Panel consent to the restrictions in Rule 21.1(a) not being applied where an

offeree board seeks to sanction a scheme of arrangement in a competitive situation, other than in exceptional circumstances; and (b) Note 10 on Rule 21.1 be introduced as proposed?

45. We agree with these proposals but also agree that this is a finely balanced issue for the reasons stated in the PCP. In our view it would potentially be preferable to refer to "wholly exceptional circumstances" (rather than to "exceptional circumstances") in N10.

Q21 Do you have any comments on the Executive's guidance as to how it would normally interpret "exceptional circumstances" for the purpose of the new Note 10 on Rule 21.1, as set out in the draft new Practice Statement No 34?

46. We have no comments on this.

Q22 Should: (a) an offeror be permitted to extend a mini-long-stop date with the consent of the Panel in a competitive situation; and (b) Sections 3(b) and 5 of Appendix 7 be amended as proposed?

47. We agree with these proposals.

Q23 Should the restriction on general enquiries in Note 1 on Rule 21.3 be deleted?

48. Yes – we agree that the approach outlined in the PCP will be helpful in reducing the administrative burden that the rules in this area currently create.

Q24 Should Rule 21.3 be amended to require the offeree board to provide promptly to the requesting offeror or bona fide potential offeror both: (a) the information that has been provided to another firm or potential offeror at the time of the request; and (b) any further information that it provides to the other firm or potential offeror in the seven days following the request?

49. We agree with the principle but would query whether it is necessary to limit the period to seven days or whether (and this would be our preference) it should remain evergreen for so long as the potential bidder remains a "bona fide potential offeror".

50. We note that the test for whether a potential bidder is bona fide is set at a very low level – it would be helpful if that Panel could provide more guidance around its approach in this particular area (including in circumstances where the potential bidder does not appear to be actively progressing its potential offer).

Q25 Should Rule 21.4 in relation to management buy-outs be amended so as to require the offeror or potential offeror on request to provide to the independent directors of the offeree company or its advisers any information that it has provided, or subsequently provides, to external providers of finance?

51. Yes – we agree with these proposals.

Q26 Should the passing of information under Rule 21.3(a) be permitted to be subject to a condition that the potential offeror must seek the offeree company's consent before sharing its information with a potential finance provider, provided that such consent cannot be unreasonably withheld?

52. Yes – we agree with this proposal.

Q27 Should the current Note 5 on Rule 21.3 be amended to require an offeree board which commenced discussions in relation to a sale of all or substantially all of the offeree company's assets before the beginning of the "relevant period" (as defined in the proposed new Rule 21.1(b)), on request, to provide an offeror or bona fide potential offeror with the information it passes to the potential asset purchaser after the beginning of the relevant period?

53. We agree with the proposal that (where the target company was in discussions with one or more potential purchaser(s) regarding the asset sale prior to the relevant period) it should be required to provide to a bona fide potential bidder any information provided to the asset purchaser after the start of the relevant

period.

54. However, we would query whether it is appropriate to require public announcement of discussions with the asset purchaser(s) or the potential bidder to have been authoritatively informed of their existence. If the asset transaction is in fact competing with the potential bid, we can see there is an argument that the bidder should be able to ask for (and receive) the information even if it has not been authoritatively informed of the existence of the potential competing asset transaction.