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HOW LEVEL A PLAYING FIELD DOES COMPANY LAW PROVIDE?

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INQUIRY INTO CORPORATE TAKEOVERS IN THE UNITED KINGDOM

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The David Hume Institute has been commissioned by The Joseph Rowntree Foundation to conduct an Inquiry into the issues raised by Corporate Takeovers in the U.K. This paper is the fifteenth of a series presenting the results of research undertaken in the course of the Inquiry, and also submissions of opinion received from individuals and organisations which are thought to be of wide general interest. The Institute hopes in this way to keep the public informed of work in progress. The Final Report will appear in June 1991.

A note on the Institute and a list of its publications appear on pp. 34-37.

The Institute has no collective views on any public policy question and is not committed to the views of any of its authors.

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HOW LEVEL A PLAYING FIELD DOES COMPANY LAW PROVIDE?[1]

"The vice with which we are dealing is the corruption of commercial life. We are dealing with the problem against the background of the climate of the City in 1986: contested takeovers were referred to as "battles" - the metaphors of war were invariably used to describe them. In such takeovers, the stakes are high, the pressures intense, and the rewards of success potentially corrupting. The danger is that, when men are hell-bent for victory, greed is in the saddle and ordinary commercial probity and the law are thrust aside in the rush. The individual voice of conscience will not be heard.

The evidence has clearly shown that aspects of the Guinness bid for Distillers were not within the law, nor were they within either the letter or the spirit of the City Code".

- Mr Justice Henry pronouncing sentence in the Guinness trial
- 28th August, 1990.

Introduction

What I have tried to do in this paper is, firstly, to assess whether pure company law (as opposed to competition law or the law relating to employment, insolvency or taxation and non-statutory regulation under the Code or the Stock Exchange listing requirements) provides a "level playing field" as between the bidder (or prospective bidder) and the target company and its directors. I then look more specifically at whether the legal constraints on insider dealing represent a major impediment to the improvement of communication between the directors and the owners of the companies which is perceived as being one of the ways in which companies can be protected against unwelcome bids.

The Approach of Company Law to Takeovers

The general approach of company law as expressed in the Jenkins Report in 1962[2] was (and still remains) that it should "avoid, as far as possible, placing obstacles in the way of honest and fairly conducted takeover transactions". It has been left largely to non-statutory regulation in the form of the Code to ensure that takeover transactions are conducted "honestly and fairly".

This general approach contrasts with the approach of other countries whose company law and practice, either by design or accident, places barriers in the way of takeovers of the type and on the scale which take place in the UK. The DTI Consultative Document on "Barriers to Takeovers in the European Community"[3] identifies a number of areas where the company law and practice of other Member States places obstacles in the way of takeovers which do not exist under UK company law and practice. That, however, must beg the question of whether the UK has not gone too far in clearing the path for the bidder.

The Specific Impact of the Law on Takeover Transactions

In accordance with its general laissez-faire approach, the law's intervention into takeover transactions is limited and, in so far as it does intervene by statutory provisions which impinge specially on takeover transactions, these are mainly directed at facilitating the transfer of control and ownership by means of a takeover bid. The compulsory acquisition procedure, for example, provides the offeror with the right to buy out a dissenting minority (CA 1985 S429) as well as giving that minority the right to be bought out (CA 1985 S430A).

The Power to Displace Management

Perhaps more importantly, the law also provides for a transfer of control at the 51% level by enabling a simple majority of the shareholders to displace an existing board (CA 1985 S303). (Although weighted voting and non-voting or limited voting shares may mitigate the full rigour of this provision,[4] these expedients are not normally available in a listed company. The "golden share" expedient employed by government as a protection for the public interest after the transfer of industries from the public to the private sector has been more often waived than exercised in takeover situations.[5])

It is, of course, a statement of the obvious to say that resort to this power of removal by ordinary resolution is not limited to takeover transactions. There is therefore no reason why, without a takeover, institutional investors commanding a sufficient majority of the votes (in practice it need not be 51%) could not displace inadequate management.

But this is a power which institutional investors decline to use, preferring what has been called by Albert O. Hirschman[6] the EXIT choice (i.e. selling their shares) to the VOICE approach of expressing their concern and stimulating the necessary board change. "They don't want the hassle." This issue of

institutional intervention in the affairs of companies with the object of promoting more effective management was discussed in a recent essay by the Group Chief Investment Manager of Prudential[7]. This is what Mr Artus wrote:

> "Any system requires some mechanism for monitoring managerial effectiveness in the use of resources. The basic fall back position is natural selection by the faster growth of the successful, and the decline and eventual demise of the unsuccessful. Efficiency is probably helped as against this slow natural process, if management improvement is brought about earlier by acquisition by better managers. But in this case the shareholders of the company acquired must expect to have to pass a substantial part of the benefit of change to the acquiring company. Surely, it is argued, shareholders should neither supinely allow managements to preside unchanged over protracted decline, nor pass the benefits of improvement to a bidder? They should rather themselves intervene to force management strengthening. Such intervention by shareholders does in fact occur from time to time, and we have been concerned with some well known instances as well as many more less publicised cases. But the extent of such activity by shareholders in Britain does not remotely approach the level where it is an effective substitute for the involvement of the banks in Germany or the Keiretsu system in Japan. Jonathan Charkham has recently argued strongly for an increase in activity by institutional investors aimed at promoting more effective management in the companies in which they are invested. My guess is that any conceivable increase in such activity will not amount to a major new element of accountability in our system matching that of the bank-based economies, since

share ownership unaccompanied by the additional involvement in providing finance and other services will never provide the depth of knowledge and commitment that arises with the combination of banking and proprietary interests."

Other Powers of Intervention by Shareholders

The opportunities and powers of intervention available to shareholders have been increased as a result of recent companies legislation (particularly the Companies Act, 1980) which has sought to impose constraints on the unfettered exercise by directors of the wide powers normally delegated to them under companies' articles of association. These constraints have taken the form of requirements for disclosure to shareholders supplemented, in some cases, by the requirement for approval by the company in general meeting. They relate to the powers of directors to issue new shares (CA 1985 Ss. 80 & 89) and to enter into transactions (service contracts and "substantial property transactions") involving conflicts of interest (CA 1985 Ss 319 & 320).

Compensation for Loss of Office

The law (CA 1985 Ss 314 & 315) also seeks to provide a measure of protection against the abuse of the directors' position at the expense of the shareholders in a takeover situation by requiring disclosure and approval by shareholders of payments to a director "by way of compensation for loss of office, or as consideration for, or in connection with his retirement from office". These provisions are, of course, known to be defective in that most compensation arrangements can readily be brought within the exceptions (under CA 1985 S316 (3)) for retirement provisions and **bona fide** payments by way of damages for breach of contract[8].

The necessity to pay compensation resulting from the premature termination of executive directors' service contracts

could prove a major impediment to the displacement of management and it is for this reason that after a bid "might be imminent" the Code[9] regards as "frustrating action" the giving of new service contracts or the extension or improvement of existing contracts "otherwise than in the ordinary course of business" or without the approval of the company in general meeting. It would seem, however, that measured against the very high costs of a contested bid, the prospective cost of dismissal of executives, which in other contexts might have been regarded as substantial, may not be a significant impediment to the bidder. On the other hand, such costs, falling as they do on the company and, through it, on the shareholders, may be a major disincentive to achieving a management restructuring outside a bid situation. (The public controversy which arose from the substantial compensation payments being made to the departing Chairman of Ferranti, even though no doubt a "**bona fide** payment by way of damages for breach of contract", perhaps illustrates one aspect of the obstacle which executive service contracts put in the way of the achievement of management changes in response to institutional shareholder concern or pressure).

The Annual General Meeting

The annual general meeting which the law (CA 1985 S366) requires companies to hold and at which the directors report and accounts have to be submitted (CA 1985 S241) provides a possible forum for voicing shareholders' dissatisfaction with management and perhaps stimulating changes. But the evidence is clear that this potential has not been utilised. Anyone who attended AGMs of the old Distillers Company will know that they were not used as a chance for institutional shareholders to give expression to their widespread dissatisfaction with management performance. If they had, the independence of an important Scottish company might have been preserved and all the traumatic events surrounding it avoided. Institutional investors have, however, tended to shy away from airing in public their individual and, even less,

their collective dissatisfaction with the management of companies.

Post-1948 Innovations in Company Law

It might be interesting to analyse whether the innovations in company law introduced since 1948 (and particularly in the Companies Acts of 1980 and 1981) have affected the respective positions of the bidder and those who seek to resist the bid.

Disclosure of Substantial Stakes

One of the reasons for the introduction of a system of disclosure of the beneficial ownership of substantial shareholding stakes in listed companies was that it would enable directors of a target company to ascertain the identity of any substantial shareholder who was in the process of "buying for control" and who might have the eventual intention of making a takeover bid.[10] It was aimed **inter alia** at the identification of those who may wish secretly to acquire a sizeable holding on which to base a bid for control This "early warning" system has, since its introduction in 1967, been much refined in respect of scope,[11] threshold and timing of disclosures as well as powers of investigation and enforcement by the imposition of restrictions in shares involved. (It is now to be found in Part VI CA 1985)[12] and has been supplemented by the Panel's Rules governing Substantial Acquisitions of Shares.[13] (These were drawn up a a non-statutory response to the "Dawn Raids" and are directed at restricting the speed at which substantial stakes can be acquired). While the system may provide time for directors of target companies to prepare their defence, the disclosure which is required very often puts a company irreversibly "into play" irrespective of the intentions of the substantial stakeholder. This can be attributed to the mandatory bid requirement of the Code[14] which makes it difficult for a genuine investor to build up a substantial stake without any clear view as to whether or not he wishes to bid for control, far less to acquire a blocking minority holding in

support of the existing management.

The Barriers to Takeovers Consultative Document[15] saw the lack of a system for the identification of major shareholdings as an important barrier to takeover on the ground that, without it, "it is difficult for a potential offeror to identify the owners of the shares or others with an interest in them and thus to make a direct approach, or even to determine in advance whether the ownership of a company's shares is such as to make a bid unlikely to succeed".[16]

It is an odd irony that a system intended initially to be of help to the directors of target companies may have turned out to be of such assistance to the potential offeror that its absence is regarded as an important barrier to the bidder.

[The County NatWest/Blue Arrow affair points in two different directions on the effectiveness of the "early warning" provisions.[17] On the one hand, the market importance of such disclosures can be gauged from the devices resorted to by County NatWest to avoid compliance with the disclosure requirements. On the other hand, it disclosed defects in the provisions which have been corrected by the Companies Act, 1989.[18] It is difficult, however, to determine whether this case which, of course, related to a rights issue and not to a bid, helps towards any conclusion as to whether the absence of a requirement for significant stake disclosures is an obstacle to takeovers or whether such disclosures provide an effective help to the board of the target company in mounting a successful defence to a hostile bid.]

Financial Assistance for Acquisition of Shares

CA 1948 S54 which, as the Jenkins Committee[19] put it, had proved an occasional embarrassment to the honest without being a serious inconvenience to the unscrupulous" and which a Department of Trade Inspectors' Report as far back as 1961 had characterised as being "generally honoured more in the breach than in the observance", was replaced by the Companies

Act 1981 by provisions, now contained in CA 1985 Pt. V Ch. VI Ss. 151-158, intended to constitute a "radical revision" of the restrictions on the capacity of companies to give financial assistance for the acquisition of their own shares.

This more relaxed (and, it is claimed, certain) regime has facilitated the financing of bids, particularly Management Buy-Outs. This is done by resort to the exception (S153) from the general prohibition (S151). To fall within that exception, it is necessary to meet the conditions (a) that the principal purpose of the assistance is not related to the acquisition in question or that the assistance is given as an incidental part of some larger purpose of the company and (b) that in either case the assistance is given in good faith in the interests of the company giving it (S153 (1)). There must be doubt whether in all cases where "financial assistance" within the wide meaning given in S152 is given by the target company as an essential part of the financing of the bid, these conditions have been wholly satisfied. It will perhaps take an insolvency to determine whether those who mount bids and those who fund and advise them may be taking too relaxed a view of these conditions and whether the reliance which they place on the more relaxed regime available (under S155) when a public company is converted into a private company is justified. In the meantime, the provisions must be regarded as helping rather than deterring those who mount a bid based on the asset cover provided by the target company. We may not have returned to the "self-financing" bid but we are not all that far off it.[20]

Section 151 and the Guinness Affair

The bid by Guinness for Distillers represented the first serious tests of the new provisions restricting the offeree company from providing financial assistance in connection with a takeover offer. Under what was called the Merger Agreement, whereby the Distillers' directors undertook to recommend the Guiness offer, Distillers undertook to pay Guinness's costs (which included the substantial costs of underwriting and

which were estimated as "likely to exceed £25 million" in connection with the takeover) if the Guinness bid did not succeed. The reason for this novel arrangement was explained in the Distillers' Chairman's letter of recommendation in the Guinness offer document -

> "During the negotiations with Guinness which led to the original merger proposal, Guinness expressed concern that, as the offeror, it would have both to pay the costs of implementing the merger and to contribute the bulk of the management time, despite being the smaller company. To meet this point and to secure agreement with Guinness, Distillers has undertaken to pay certain of Guinness' external expenses, in specified circumstances, should a merger not be completed".

The legal issues which the arrangement raised were described by the Judge in his summing up at the Guinness trial -

> A company can only in certain specified cases give financial assistance to the purchasers of its shares. This legal problem was principally a problem for Distillers. The lawyers for Distillers and the lawyers for Guinness concluded that if Distillers agreed to pay Guinness's costs should Guinness fail in the bid, that would be lawful, but because the law had just been changed, they could give no guarantees.
>
> Now as I say, Distillers' directors were the most immediately concerned. They were first in the firing line. If the law was broken, there could be both criminal and civil consequences. But having taken advice, the Distillers' Board finally agreed to the merger agreement but only on terms that Guinness, in their turn, indemnified Distillers' directors of any personal liability in civil proceedings up to the tune of £25 million.

Although the arrangement was challenged before the courts by the competing bidder, Argyll, the matter was not decided because the bid succeeded and the indemnity was not required to operate. (Argyll's challenge of the arrangement before the Panel did not succeed, the Panel upholding a ruling of the Panel executive that the amalgamation "did not constitute frustrating action in breach of the Code".[21]

The second test of the new restrictions on financial assistance in the Guinness context related to the market support operations which were the subject of the prosecutions: these involved indemnities against loss and the promise of success fees given by Guinness. Again the effectiveness of the provisions was not tested in that the charges for breaches of the statutory prohibition were not put to the jury on the basis that they were really subsumed within the wider and more serious charges of conspiracy to create a false market, theft and false accounting of which the accused were found guilty. The judge, however, relied on the statutory prohibition as well as the law's more general insistence that markets should be fair and not rigged to support his general direction to the jury "that for a party in a takeover battle to agree to pay secret (i.e. undisclosed) indemnities and success fees to those who purchase their shares, is unlawful".

It must then remain an open question whether the new provisions will prove effective to deter market support operations which, while they may not go to the extremes of the Guinness case, caused a cynical commentator to observe that the fates of great companies are decided on the basis of two rigged prices at a given date. (I reserve judgement on whether the Code will have a greater degree of success in curbing this abuse. The Panel would claim that the much closer monitoring, which it now is able to do, of dealing in the course of a takeover, should substantially prevent the deliberate creation of false markets in takeover stocks).

The company's power to buy its own shares

The ambivalence of the recent innovations in company law persists in relation to the power given to companies by the Companies Act 1981 to buy their own shares (now CA 1985 Pt. V Ch. VII). It might seem that this power would assist the board of a target company by enabling the company to enter the market and support the price of its shares and so make the company less attractive to the bidder. However, the restraints imposed by the law directly in relation to the power and indirectly under the Insider Dealing Act, as well as by the Stock Exchange under its listing requirements, make this power of limited effect on the market for a company's shares. In an actual takeover situation, the power is largely irrelevant since its exercise would probably constitute "frustrating action" under the Code and, in any event, the resultant cancellation of any shares purchased would only make it easier for the bidder to achieve the requisite majority of the remaining shares.

The use of the "buy-in" power by Guinness

The Guinness takeover of Distillers illustrated a use to which the facility for a company to "buy-in" its own shares could be put in the context of a takeover. The circumstances were described in the Guinness circular to its shareholders of 23rd May, 1986 in which they sought such consents as might be necessary to implement a proposal under which certain Guinness stock units issued pursuant to the offer for Distillers would be purchased for cash by Guinness and cancelled. In the course of the bid, Distillers' shares representing 14.97% of Distillers' issued equity had been bought by "certain banks who were deemed (under the Takeover Code) to be acting in concert with Guinness". In essence the proposal was the the Company should "buy-in" the Guinness stock units which these banks had received under the Guinness takeover offer in exchange for the Distillers' shares which they had purchased. The prices were based on the prices paid by the banks for the Distillers' shares with the addition of interest from the date of

their purchase to the dates when their Guinness stock was "bought-in".

This arrangement was described by Mr. Roux, the Financial Director of Guinness at the time and a key prosecution witness in the Guinness trial, as "a brilliant idea" which had been thought up by Mr. Parnes, one of the accused, and had been worth millions of pounds to Guinness. This assertion was, of course, made in support of a claim that a fee of £3.3 millions paid by Guinness to Mr. Parnes in connection with the takeover was money "well earned". The proposal was accepted by the Guinness shareholders on the basis of the Board's advice that it represented "an excellent investment for the Company" and that "the redeployment of the cash which would otherwise be paid to shareholders of Distillers (if they had elected for cash rather than shares in Guinness) through this proposal, will achieve the Guinness' Board's objective of ensuring a balanced capital structure for the Company as well as contributing towards a greater demand for the Company's remaining issued stock units".

All that was, however, before the roof fell in with the appointment of the DTI Inspectors at Guinness in December, 1986. It remains to be seen whether this "brilliant idea" will be resorted to in the future. It could provide an alternative to sales in the market, with the possibility of depressing the share price, for certain parties who find themselves, as a result of their disclosed, and totally permissible, purchases in support of a bid, with a substantial stake in the successful bidder which they will wish to get rid of.

Power of directors to issue shares.

The restrictions imposed by the Companies Act 1980 (and now to be found in CA 1985 Ss. 80 and 89) on directors' powers to issue new shares without the approval of its shareholders might have been thought to place some obstacle in the way of the board of the prospective bidder. The practice, however, of

directors in taking at annual general meetings powers which effectively circumvent the restrictions means that they have very limited impact on the capacity of a bidder to mount a bid; the Stock Exchange's requirements in regard to acquisitions and disposals are of much greater relevance.[22] A doubt must remain whether the shareholders of offeror companies have sufficient rights to enable them to restrain the exercise by directors of their powers to make bids.

The development of the general law

Outside the scope of the statutory provisions, the development of the law in relation to the duties of directors in a takeover situation places considerable inhibitions on the ability of directors of target companies to resist a bid. In what I still regard as the classic statement of what constitutes "the interests of the company" in the fiduciary duty of directors to act **bona fide** in what they consider to be in the best interests of the company, Senior Counsel advised the Board of the Savoy Hotel in 1954 that in the phrase "the best interests of the company" the expression "the company" did not mean the sectional interest of some (it may be a majority) of the present members, but of present and future members of the company and that "the board should conduct the company's business upon the footing that it would be continued as a going concern and accordingly **should balance a long-term view against short-term interests of present members**".[23]

It seems to me that, perhaps influenced by the Code with its insistence on the interests of the **present** shareholders as opposed to the interests of the company with its element of longer term considerations, the law is increasingly recognising that, confronted with an actual or prospective takeover bid, the directors' duty to have regard to the long-term interests of the company is subordinate to a duty to the present shareholders either to get them the best price or demonstrate that rejection of the offer is in their (not the company's) best interests.

The Dawson International/Coats Paton Case

This is an issue which engaged the Scottish courts in the litigation involving Dawson International and Coats Paton.[24] That case was concerned with the recovery of expenses by a bidder where the directors of the offeree company, having originally agreed to recommend the bid, withdrew their recommendation in the face of a better offer from another bidder. The judgments at the various stages of the case highlighted the legal uncertainty about the position of directors faced with a takeover bid. Lord Cullen in the Outer House said -

> "At the outset, I do not accept as a general proposition that a company can have no interest in the change of identity of its shareholders upon a takeover. It appears to me that there will be cases in which its agents, the directors, will see the takeover of its shares by a particular bidder as beneficial to the company. For example, it may provide the opportunity for integrating operations or obtaining additional resources. In other cases, the directors will see a particular bid as not in the best interest of the company".

but went on -

> "In contrast, I see no good reason why it should be supposed that directors are, in general, under a fiduciary duty to shareholders, and in particular, current shareholders, with respect to the disposal of their shares in the most advantageous way. The directors are not normally the agents of the current shareholders. They are not normally entrusted with the management of the shares".

And in his Opinion, Lord Prosser undertook an interesting analysis of how far the requirements of the Code may affect legal obligations. These observations, however, do little to

dispel the doubt and uncertainty of the legal positions of directors faced with a takeover offer. In particular, it seems to be far from settled that in a takeover, the object of directors' primary responsibility moves from the company to the shareholders. On the other hand, apart altogether from the Code's restrictions on frustrating action, I think that directors of target companies would have difficulty in defending before the courts defensive actions which they took in the genuine belief that they were in the best interests of the company as that expression was interpreted by the Savoy Hotel Counsel.

An MMC Reference as a Defence

One of the principal defensive actions open to the board of the offeree company is to seek to have the hostile bid referred for investigation by the Monopolies and Mergers Commission. To date, no attempt has been made to challenge such an action either on the ground that it is in breach of the directors' fiduciary duties or constitutes a frustrating action in terms of the Code. The prospect of a successful challenge cannot, however, be totally ruled out, especially if substantial corporate resources are devoted by the Board of the target company to a campaign designed to persuade the Secretary of State to refer the bid to the MMC.[25]

Conclusion

The conclusion of this review of the law in relation to takeovers must be that the law gives little support and encouragement to the directors of companies resisting a bid. Despite all that has happened since 1962, it has not moved away from the approach it adopted in the Jenkins Report that the law should not place obstacles in the way of honest and fairly conducted takeover transactions. If anything, the movement has been to remove obstacles and for evidence of that, one has only to look at the Barriers to Takeovers Consultative Paper which holds up the UK approach, statutory as well as non-statutory, as providing the best environment for the takeover activity

which the Government regards as a necessary spur to efficiency within the completed internal market.

INSIDER DEALING AND MANAGEMENT ACCOUNTABILITY

I now turn to the tension between "insider dealing" and "management accountability". In his foreword to the Conference Papers,[1] David Bennett wrote:

> "Nor is it satisfactory to preach the need for management to retain shareholder loyalty when the only really effective steps in that direction may infringe the law against insider dealing".

The restraints on insider dealing were introduced by the Companies Act 1980 and are now contained in the Company Securities (Insider Dealing) Act 1985. This makes it a criminal offence for an insider either (i) to trade in the securities market on the basis of inside information or (ii) to recommend or procure others to trade on the basis of inside information or (iii) to disclose inside information to another knowing that such disclosure would, or would be likely to, lead to insider dealing.

The Problem

It is claimed that these prohibitions, which are accepted as being necessary to maintain confidence in the securities markets, constitute a major obstacle to that continuous communication of information by companies to their principal shareholders which is considered essential to achieve the support of shareholders when a hostile predator appears. The problem was described in the CBI City/Industry Task Force report[26] as follows:

> However, companies face a dilemma in their choice of channels of communication. If they provide

> market-sensitive information only on request to a small group of shareholders/analysts, they run the risk of breaking Stock Exchange rules and, in an acquisition situation, those of the Takeover Panel, by not treating shareholders equally. If individuals act on such inside information ("insider dealing") they may be in breach of the law. On the other hand, to make available to all shareholders information that is required only by a few can be very costly and time-consuming.

This dilemma was expanded upon in the Consultative Paper on the Law on Insider Dealing issued by the DTI following the adoption on 13th November 1989 of the EC Directive Co-ordinating Regulations on Insider Dealing.

> To ensure the fair and orderly markets it is important that information is made available to the whole market at the same time. For securities officially listed on the International Stock Exchange the rules on admission to listing contain details both of the obligations assumed by companies and of the procedures to be followed. In addition special precautions, set out in the Takeover Code, need to be taken in connection with takeovers. The Government attaches considerable importance to good communications between companies and the City, and believes that the practice of explaining the details of company operations to analysts and fund managers has an important part to play in this. Nevertheless it is equally important to ensure that price sensitive information is not selectively disclosed. Disclosure of price sensitive information in confidence poses particular problems for all concerned: the analyst to whom such information has been disclosed could be in breach of the existing criminal law if he were to use the information prior

to publication. Furthermore it is possible that, depending on the circumstances of the disclosure, the individual making the disclosure may himself be committing a criminal offence. Therefore if, on reviewing what has been said at a meeting, company representatives believe that they may have unwittingly revealed some unpublished price sensitive information, they should immediately disclose that information to the Stock Exchange, for publication to the whole market.

Before we consider that dilemma further, it is perhaps worth questioning the validity of the assumption that improved communication on a "regular and open" basis between a company and its principal shareholders will improve the chances of obtaining their support against an unwelcome bid. I raise a doubt as to whether any amount of communication or any greater emphasis on investor relations will bridge the gap between the market price of a company's shares **ex** a bid and price **cum** the bid premium and so persuade investors to forgo the prospect of a favourable realisation out of loyalty or even confidence in the existing board and its assessment of future prospects.

If, however, we accept that improved communication may improve the chances of "seeing off" an unwelcome bidder, there is a dilemma as described in the above extracts.

The Impact of the Law

For the directors of the company the dilemma lies in the fact that, to communicate inside information to persons such as fund managers who are clearly likely "to make use of the information for the purpose of dealing or of counselling or procuring any other person to deal" constitutes an offence under S1(8) of the Insider Dealing Act. For the recipient of the information it means that he becomes an insider and so cannot deal, or "counsel or procure" others to deal. This is a particular

problem for the fund manager and the danger that he may find himself in this position has been accentuated by the possibility that he may become the "involuntary recipient" of inside information and so (on the basis of a court decision on the interpretation of the Insider Dealing Act)[27] become subject to the prohibitions under the Act. The dilemma is particularly excruciating to the fund manager. Like all market participants, he lives on information and it is not surprising that he does not take kindly to finding himself in the position of having got worthwhile information, but precluded from doing what he wants the information for, namely, to deal And what is worse, the prohibition is absolute arising as it does from the possession of the insider information and is not restricted to dealings "on the basis of the inside information" but extends to all dealings until the information in question comes into the "public domain" or, more accurately, ceases to be "unpublished price sensitive information" (as defined in S10 of the Insider Dealing Act) by becoming "generally known to those persons who are accustomed or would be likely to deal in" the securities in question.

What is inside information?

The uncertainties in the statutory definition of "unpublished price sensitive information" add to the difficulties of communication between a company and its shareholders. When does information relate to "specific matters relating or of concern to" the company in question or when is it "of a general nature relating or of concern to" the company? Is the information such that if generally known to dealers or potential dealers, it would be "likely materially to affect the price of" the company's shares? And outside the definition itself, is the information of a kind which "it would be reasonable to expect" a person in the position of the primary insider "not to disclose except for the proper performance of the functions attaching to that position"? It is all very difficult.

There is little wonder then that at least some fund managers seek to distance themselves from the company and refuse to attend briefings even after publication of the company's results when the state of knowledge of the directors and the investors should most closely coincide.

The Effect of Chinese Walls

I am not clear whether Chinese Walls contribute to the solution of the problem. In that they restrict the flow of information between the corporate advisory and the fund management sides of large securities houses, they might be said to be an impediment to the process of communication between a company and its principal shareholders. On the other hand, this may make little difference since the information whose flow is restricted is likely to be of such a price sensitive character that, if known to the fund management side, the fund managers would be in any event precluded from dealing under the Act. The fact that by virtue of a Chinese Wall the fund management side does not have the information does not necessarily leave them free to deal without contravening the Act and, even if they were free, they would likely be subject to some form of internal restriction on dealings. The conclusion must be that in an actual or prospective bid situation, Chinese Walls are unlikely to make it easier for institutional investors who would otherwise be subject to constraints on their dealing capacity, by virtue of an insider position, to engage in market operations in support of a board defending against a bid.[28]

An Unresolved Problem

The prohibitions on insider dealing then clearly present difficulties for companies who wish to engage in a selective dialogue with some of their shareholders. Even if directors take a relaxed view (they might call it a practical and realistic view) of the constraints imposed on them under the Act on the ground that they can conduct such a dialogue in a meaningful way without straying into areas of "unpublished

price sensitive information" they may find those on the other side reluctant to engage in the dialogue. This communication gap is likely to increase rather than diminish when a hostile bid is on the table. Then the Code causes everyone to proceed with great caution to ensure that no shareholder or section of shareholders gets information which is not generally available. Again, it is all very difficult.

The CBI Task Force's Proposals

The CBI Task Force[26] made some proposals aimed at reducing the problem. They suggested, as a cost-effective way of bringing all the relevant facts into the public domain (and so outside the scope of insider dealing), that the content and style of annual reports might be expanded and improved by giving information on such matters as expenditure on research and development, factors which contribute to innovation, the company's objectives and long-term strategy and likely developments in the company's main markets. These are modest proposals and do not provide (and, indeed, would not claim to provide) anything like a solution to the difficulty.

The Task Force's Suggestions

The CBI Task Force Report did, however, make two other suggestions to improve investor relations which perhaps merit comment.

1. **More use of non-executive directors**: The Task Force felt that institutional investors "should be encouraged to seek ways of conveying concern through non-executive directors and possibly in association with other major shareholders". This otherwise laudable approach has dangers in that it may put the non-executive director who is the recipient of these concerns into a potentially difficult position where he may be perceived as the agent of a sector of the shareholders and so with an interest which conflicts with his fiduciary duties as director to the company

and to the shareholders as a whole. The "ways of conveying concern" would have to be chosen with care since any resultant dialogue could give rise to the difficult questions in relation to insider dealing identified earlier in this paper and, further, the fact of any approach to a non-executive director might of itself constitute unpublished price sensitive information, causing problems for the institutional shareholder making the approach and any other shareholder associated with it.

2. **Dialogue between companies and pension fund investors**: The Task Force's recommendation was as follows:

   Managements, where they have the power to appoint trustees, should review their trustees arrangements to ensure that suitable trustees are selected and that the trustees are able, willing and trained to fulfil their responsibilities properly, including their responsibilities for investment. The Task Force also recommends that company managements should undertake a dialogue with trustees to explore those investment issues which they believe it is important for the trustees to consider carefully and on which trustees should be urged to develop a well thought-out position, including:

   (i) the responsibilities of pension funds as shareholders (for example, the exercising of voting rights);

   (ii) the setting of achievable objectives and guidelines for investment managers; in particular the risk profile which investment managers adopt;

   (iii) self investment (i.e., investment by the pension fund in a company's own stock);

   (iv) arrangements for the appointment of investment managers and monitoring their track record.

While these recommendations are generally to be welcomed, their effectiveness in relation to the improvement of companies-investor relations must be limited by the pension fund trustees' paramount duty under trust law to look to the best interests of the beneficiaries, actual and prospective, of the funds for which they are responsible. As was made clear in the court's decision in the National Coal Board Pension Fund case[29], trustees cannot accept any restriction on their freedom to invest or make investment decisions on other than investment criteria. The recent cases on pension fund surpluses[30] suggest that the courts will resist any attempt by companies to ignore the trust nature of pension fund arrangements or to influence the trustees to act otherwise than in accordance with their fiduciary obligations. Trustees must be particularly wary of any attempt to persuade them into investing in the company's own stock where, apart from the ultimate risk of loss on the failure of the company itself, their investment decisions will be subject to all kinds of extraneous constraints including, but by no means limited to, the insider position of some of their number.

The Joseph Rowntree Memorial Trust and the Nestlé bid for Rowntree[31]

The constraints which trust law imposes on the ability of "friendly" trustees to support an existing board in their defence against a hostile bid were experienced by the Trustees of the Joseph Rowntree Memorial Trust in their attitude to the Nestlé bid for Rowntree. The Trust is a registered charity established in 1904 by Joseph Rowntree, the founder of the company, with an endowment of a substantial shareholding. It held at the time of the bid 3.8 per cent of the issued share capital of Rowntree. It was (and remains) an entirely separate and independent legal entity both from the Company and other Rowntree Trusts: none of its Trustees was, at the time of the bid, on the Board of Rowntree plc or employed in any capacity by it. In its Deed of Formation in 1904, the founder of the Trust expressed the wish that the Trustees should not sell their Rowntree shares unless they considered a sale "to be

necessary for the purposes, or in the interests of the Trust". Counsel advised the Trustees that, while a "wish" of the founder cannot compel or authorise the Trustees to act in a manner different from that in which (in the absence of that wish) they would feel obliged to act in the interest of the Trust as a whole, the Trustees were, nevertheless, entitled and indeed bound to look at the overall benefit of the Trust. In reaching their decision, they had to take into account all the material circumstances including non-financial as well as financial considerations.

It was in the light of that advice that the Trust announced its initial support for the Rowntree Board's rejection of the Nestlé bid, explaining that Rowntree had been an excellent long-term investment for the Trust and that the Trustees believed that it could continue to be so as an independent company. The Trustees added significantly, reflecting the non-financial considerations of which they had to take account, that in addition to being convinced about the adequacy of price, they would, in making any decision in relation to the bid "attach great importance to non-financial issues such as the location of the international headquarters of any enlarged confectionery business and the degree of freedom which Rowntree would have, in the event of a takeover, in maintaining its traditional policies in relation to people and to the communities in which it operates".[32]

The Trustees, however, recognised that there were limits on the extent to which they could allow non-financial considerations to outweigh purely financial considerations. And lest they might be minded to do so, the Attorney General, stimulated by a press report that, come what may, the Trust, along with the Joseph Rowntree Charitable Trust (together they held about 7 per cent of the Rowntree shares) had "pledged their support to keep Rowntree independent", intervened to remind the Trustees of the obligations imposed by their charitable status.[33] (The Attorney General eventually conceded that he was entirely satisfied that the Trustees had acted properly).[34]

And so when Nestlé revised their offer and obtained the recommendation of the Rowntree Board, the Trustees, having obtained some assurance about the place of Rowntree in the Nestlé Group, decided that it was not in the interests of the Trust to remain as a minority shareholder in Rowntree and accepted the offer. They did so with some reluctance, explaining that they would have preferred to remain shareholders in an independent Rowntree and that they very much regretted that they would no longer have "the direct shareholder link with the Company and its people who have created an excellent investment for the Trust since its formation in 1904".[35]

That cautionary tale repeats a lesson which the boards of target companies ignore at their peril. It is that in the crunch, they can only rely on friendly and supportive shareholders up to a point and that that point is normally reached by reference to the value of the bid. Those who have fiduciary responsibilities, however much they may want to support a threatened board, can only go so far on considerations of gratitude and loyalty. In the end, those considerations have to be subordinated to purely financial considerations.

It is outside the scope of this paper to speculate as to the weight which the Trustees of the Joseph Rowntree Memorial Trust put on the assurances which they got from Nestlé or on how far, in the light of what has happened since, they were justified in relying on these assurances. Those who have attempted to monitor the observances by acquiring companies of statements made in offer documents about their intentions regarding the acquired company and its employees as required by the Code,[36] must view such assurances as the Trustees received with more than a little scepticism. That is not a criticism of the Trustees: they had no alternative given the constraints which the law imposes on trustees or others with fiduciary responsibilities.

The conclusion of Lord Young, then the Secretary of State for

Trade and Industry who declined to refer the bid to the MMC, is interesting. In his book "The Enterprise Years"[37] he wrote in the chapter called "The Rigours of Regulation" -

> "In the end Nestlé won, and Suchard retired hurt, nursing a considerable profit. In years to come, Nestlé was to put their world headquarters for chocolate in York. None of the dire events predicted by all the opponents of the bid came to pass, and even Mr. Dixon, the head of Rowntrees, ended up on the Nestlé board. The decision had sent a strong clear signal to all British companies. We were not going to protect them from an overseas bid. That was their job, and to do that they had better make sure that they keep the shareholders happy. Of course, if there were special grounds, then that would be different."

Again I leave it to others to assess the validity of Lord Young's rather sanguine conclusion in regard to the outcome of the Nestlé bid for Rowntree and whether the "strong clear signal" which he had sent has been received and understood and its implication fully accepted as being in the interests of Britain and its economy.

A Final Assessment

The advantages to be gained by giving effect to the recommendations from the CBI Task Force must be regarded as limited, viewed against the objectives of improving communication and relations generally between a company and its investors and particularly its institutional investors. And, taken with the constraints on company-investor communication necessary to avoid falling foul of the insider dealing prohibition, the conclusion must be that, as in relation to company law generally, we must look outside company law if we wish to create a climate where takeover activity will be reduced on the grounds that hostile takeovers either are

unnecessary as a means of displacing unsatisfactory management or are unattractive to the predator when he measures the potential advantage to him from a successful outcome against the "trouble and strife" as well as the uncertainty and cost of achieving that outcome. That conclusion assumes, of course, that the present philosophy that the law should not put barriers in the way of takeovers survives the next General Election. It assumes, too, that the UK does not move away from persuading others to remove the "barriers to takeovers" to a more European philosophy or a business culture which, instead of regarding as unethical the types of defensive tactics employed in the USA (like the "poison pills") regards the possibility of predators seizing control of companies without regard to the interests of companies as itself being unethical. Stranger things have happened.

NOTES

1. This paper is an updated, revised and expanded version of a paper delivered by Professor Jack to a Conference held by the Law Society of Scotland on 5th March, 1990 under the title "Whose Business are Business Mergers?"

2. Report of the Company Law Committee (1962) (the Jenkins Report) - Cmnd. 1749. para 265.

3. Barriers to Takeovers in the European Community - a Consultative Document issued by the DTI in January, 1990.

4. See **Bushell - v- Faith (1969) 2 Ch 438.**

5. The most notable example related to the bid by B.P. for Britoil in December, 1987.

6. Exit, Voice and Loyalty by Albert O. Hirschman (Harvard University Press, 1970).

7. "Creative Tension". A collection of essays in issues arising from the relationship between the management of public companies and institutional investors published by the National Association of Pension Funds - February, 1990, at Page 14.

8. See Professor Gower's Report on his Review of Investor Protection (Part 1) Comnd 9125, (1984). His recommendations for tightening up the provisions were not accepted.

9. The City Code on Takeovers and Mergers (Third loose-leaf edition: 25.10.90) General Principle 7 and Rule 21 (Note 6)).

10. Jenkins Report para. 142.

11. It now includes (CA 1985 S204) provisions which seek to translate into statutory form the Code's concept of the

"concert party" and so prevent avoidance of the obligation by "groups" of persons acting in agreement where each individual's stake is less than the minimum level for disclosure but the collective stake of the group is at or above that level.

12. In consequence of the share support operations which came to light in relation to the Guinness bid for Distillers, the threshold and the time for notification have, by the Companies Act, 1989, been respectively reduced from 5% to 3% and from 5 days to 2 days.

13. Rules governing Substantial Acquisitions of Shares which restrict the speed at which a person may increase his holding of shares to an aggregate of between 15% to 30% of the voting rights of a company and require accelerated disclosure of acquisitions of shares relating to such holdings.

14. The Code (General Principle 10 and Rule 9) requires a general offer to be made when a person's holding (with the addition of the holdings of those acting in concert with him) reaches 30% or more of the voting rights of the Company.

15. Barriers to Takeovers in the European Community: (See note 3 above) pp. 16 and 17.

16. On 12th December, 1988 the European Community adopted the Major Shareholdings Directive designed to achieve publication of major holdings and changes in those holdings in listed companies. The implementation of this Directive, which is the subject of a Consultative Document issued by DTI in February, 1991, should bring the Community into line with the UK system.

17. See Inspectors' Report on the investigation into the affairs of County NatWest and County NatWest Securities (1989).

18. This has been done by the introduction into CA 1985 of a new section (Section 210A) which gives the DTI power, by statutory instrument, to amend **inter alia** the minimum level for disclosure, the time limit for disclosure and the definition of interests which have to be disclosed.

19. Jenkins Report para. 176.

20. This comment should, perhaps, be qualified in the light of the judgements (in particular, that of Lord Oliver in the House of Lords) in the case of **Brady -v- Brady [1988] 2 W.L.R. 1308 (HL)** which caused the authors of the latest edition (5th Ed. Vol 1) of Weinberg and Blank to observe (at page 3076) -

    "While the full consequences of the decision are not yet clear, what is clear is that the provisions in Section 153 will be carefully - if narrowly - construed: the courts will not allow these provisions to be used to side-step the prohibition contained in Section 151."

21. Takeover Panel Statement 1986/2 - 29th January, 1986.

22. The Stock Exchange "Admission of Securities to Listing" (the Yellow Book) Section 6 Chapter 1.

23. Second Savoy Hotel Investigation; Report of 14th June, 1954 by Milner Holland QC - passage quoted in Palmer's Company Law (24th Edition) on page 936.

24. See 1988 S.L.T. 854 and 1989 S.L.T. 655 and Lord Prosser's final judgement in the case issued on 22nd March, 1991 and so far unreported.

25. For a fuller discussion of the issue in relation to competition policy authorities generally (including the EEC) see Competition Policies as Takeover Defences - Stephen Lofthouse 1984 JBL 320.

26. Investing for Britain's Future: Report of the CBI City/ Industry Task Force (October 1987).

27. Attorney General's Reference No. 1 of 1988 (1989) 2 W.L.R. 195.

28. Lord Prosser's account in his Opinion on the Dawson International/Coats Paton case (see note 24 above) of the negotiations between the parties illustrates another way in which the restrictions on insider dealing impacts on the conduct of takeovers. It was considered by Dawson that the communication to them by Coats Paton after the "agreed merger" had been announced of information that a "fly had been cast" in Coats Paton's direction by an alternative bidder might have the effect of inhibiting the purchase by Dawson of Coats' shares on the ground that the information which they had received was "insider information".

29. Cowan and Others -v- Scargill and Others [1985] 1 Ch 270.

30. Imperial Group Pension Trust -v- Imperial Tobacco (1991) 1 All E.R. 66: and Mettoy Pension Trustees Limited -v- Evans (1990) 1 W.L.R. 1587.

31. In writing this piece I have been much helped by Sir Donald Barron, the Chairman of the Joseph Rowntree Memorial Trust, who has made available to me copies of the Deed of Foundation, the Opinion which the Trustees obtained from Counsel and the public statements made by the Trustees at various stages of the Nestlé bid. The opinions expressed are my own.

32. Public Statement issued by the Joseph Rowntree Memorial Trust on 31st May, 1988.

33. Report in The Independent on 4th June, 1988 headed "Attorney warns Rowntree Trustees on bid" and

comment in the same newspaper on or about 8th June, 1988 headed "Uncharitable Interference"

34. Public Statement issued by the Joseph Rowntree Memorial Trust on 9th June 1988.

35. Public Statement issued by the Joseph Rowntree Memorial Trust on 20th July, 1988.

36. The City Code on Takeovers and Mergers Rule 24.1.

37. The Enterprise Years: A Businessman in the Cabinet by Lord Young (Headline: 1990) on page 272.

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