# COMPANY LAW ADVISORY COMMITTEE
## Memorandum on Take-over Bids and Stock Exchange Purchases

1. The question has been raised whether the opinion expressed in our report of 28th February 1969, in favour of allowing a takeover bidder complete freedom to buy shares on the Stock Exchange during the currency of the offer, should be embodied in the legislation, or whether the legislation should aim at giving equality to all shareholders, along the lines of the solutions suggested or adopted in the United Kingdom or the U.S.A.

2. We have been furnished with a copy of a memorandum in which the view is expressed that the United Kingdom solution is the correct one.

3. It will be recalled that in our report we pointed out that two views were possible as to the attempt to procure equality in such a case. One was that a shareholder who accepted the bid should be entitled to receive a higher price if the offeror subsequently gave a higher price to another shareholder to induce him to sell. The other view was that a shareholder who elected to hold out for a higher price was entitled to the advantage so gained, and that there was no injustice in denying a similar increase to one who had elected to accept the offer early. In proposing a draft which favoured the former solution, we included a qualification to the effect that the restriction on paying a higher price (otherwise than by way of variation of the offer) should not apply to a purchase made in the ordinary course of trading on the Stock Exchange. We did not elaborate our reasons for making this exception, although it is apparent from other parts of our report that, in the case of listed shares, we were concerned to maintain the freedom of the market afforded by the stock exchanges. In this memorandum we have attempted to set out the considerations which actuated us in making the recommendation.

**The Importance of a Free Market:**

4. Where a takeover bid is made for listed shares, the shareholder will normally base his Judgment as to whether the consideration is adequate on the stock exchange quotation. If the

shares are unlisted, the assessment of their true value is extremely difficult, but we are not here concerned with unlisted shares. Publication of the intention to make a takeover offer is almost invariably accompanied by an upsurge of activity in a listed stock, and it is the result of this activity that enables the shareholders and their advisors to decide whether the offer is a fair one or not. Accordingly, a prudent or a well-advised shareholder will wait to see the effect on the market before deciding whether to accept the offer. If the market goes above the level of the offer, the shareholder will have to decide, as in every case of market activity, whether he will sell at that price or take his chance of a further rise, knowing that the takeover price will probably still be available if the buying pressure is not sustained. But in this respect, all sellers have an equal chance, and their position is no different from that of any investor who owns shares which are quoted on an exchange.

5. If the market is to be a free market, however, it is in our view of fundamental importance that the person who is most interested in acquiring the shares should not be handicapped in the contest. He is already under a handicap imposed by the fact that if he elects to compete in the market he is in danger of defeating his own ends by pushing the price to a point at which no one will accept the takeover offer, even if he succeeds in forcing other buyers out of the market. If, however, every bid he makes has a multiplier effect, in that he must pay the increased price not only to the seller on the exchange but to everyone who accepts his takeover offer, his opponents can frustrate his bid by forcing the market price up to a level which he cannot afford, and to do this they will not necessarily have to buy a large quantity of Shares. Moreover, if the offeror enters the market his opponents will be in the happy position of being able, if they do not acquire enough shares to defeat the takeover, of being able to accept the offer at the higher price which the original offeror is now to be compelled to pay (unless the legislation is to be so framed that the right to get the higher price is available only to those who have accepted before the

higher price was reached, a solution which seems to present insuperable difficulties.)

6. The conclusion to be drawn from this is that if the U.K. or U.S. system is adopted the offeror will be virtually compelled to stay out of the market once his offer has been made. The leverage possessed by his opponents will be such that unless their resources are very limited indeed, it will be pointless for him to enter the fray. On the other hand, the decision of the shareholder is not made any easier. Since it will be easier to defeat takeover bids, and since he is assured of getting any higher price if the offeror enters the market, he may be tempted to accept early, only to find that all the other shareholders have taken the same view, and all have missed their chance of getting a higher price. On the other hand, the longer they stay out the greater the chance that the opponents of the bid will acquire enough shares to defeat the bid altogether, and they will be left with the old directorate and the old dividend rate. It is to be noted that, whereas the takeover legislation is designed to give shareholders plenty of time for decision, the tendency of the proposed rule is to encourage early acceptance of the offer.

**Equality under the S.E.C. System:**

7. Under Rule 10b-13 of the Securities and Exchange Commission, a person who makes a tender offer, and who, during the period of such offer, purchases securities otherwise than pursuant to the offer, must also purchase all tendered securities at a price equal to the highest price paid or at the tender offer price, whichever is the higher. At the time of promulgating this rule, it appears that the Commission invited comment as to whether the rule should also apply in respect of purchases made immediately prior to the making of the tender offer, which we take to mean that it was contemplating that the offeror should be obliged to pay to the persons tendering securities a price based on purchases made before the tender offer was made.

8. The S.E.C. rule certainly ensures that those who tender securities pursuant to the tender offer are not less well-treated

than those who sell to the offeror in the market. It does not, however, produce absolute equality, since it does not appear to do anything for those who sell in the market at a price below the highest price. Indeed, such a person may well feel that he has a grievance, since those who rushed in with an acceptance without waiting to see the market response will be better treated than the investor who waited because he thought the tendered price was too low. But we would think that the main result of the U.S. rule would be to keep the offeror out of the market altogether. For reasons already stated, this is more likely to work to the disadvantage of shareholders as a class than if he were left free to decide whether to buy in the market or not.

**Equality under the London City Code:**

9. Somewhat similar considerations apply to the position under the London City Code, which is, as we understand, a recommended code of conduct without compulsive force. The difference in the method of calculating the increased price means that some sellers in the market will get more and some less than the price received by those who accept the takeover offer. It is not clear on what principle the weighted average is adopted. The S.E.C. view proceeds on the assumption, as we see it, that the offeror ought to be compelled to pay to all shareholders what he was willing to give to any one shareholder. If the object of taking the weighted average is to calculate an average market price, it seems illogical to exclude consideration of the fact that some shareholders have accepted the price named in the takeover offer. It would, of course, be still less logical to include these acceptances in calculating the average and then to increase the amount receivable by those shareholders on the basis of the average so calculated. Nor is it clear why the weighted average is limited to purchases above the offer price. In many cases, sales are made below the offer price for some time after the announcement of the takeover offer, and if an average is to be taken over the whole period it is difficult to see why the offeror should not have the benefit of such lower sales.

But, as we have said, under either scheme some sellers who have chosen to wait to see what the market reaction is and have sold their shares at a better price than the takeover offer will fare worse than those who thought the takeover price was a good one.

**Use of the market as a "loophole":**

10. The memorandum under discussion suggests that if the draft is left in its present form the exemption of market buying will leave a loophole so wide that it may become of little effect. This comment assumes that our intention was to provide that every seller should receive the same price, and also that where there is a market the offeree will usually accept as soon as the offer is made. As to the second assumption, we do not think prudent or well-advised shareholders would adopt this course. As to the first assumption, in cases where the shares are listed, we think it is much more important to allow market forces to operate than to ensure equality, since in our view it is better that the shareholders should get a higher aggregate price for their shares, even if some get more than others, than that they should all get an equal amount per share with a lower aggregate price. Moreover, we do not think that the "loophole" is as wide as has been supposed$_r$ since the offeror, if he bids too high in the market, will not get many acceptors for his original offer. The comment in the memorandum, that "in this way, the obligation to pay increased consideration to those who had previously accepted would be avoided" seems to assume that such an obligation ought to exist in all circumstances. A similar assumption is involved in the expression "If it is a general principle that an offeror should pay one price for all stock acquired within the period of the formal offer ......." The above analysis, in our view, indicates that there are good reasons for not imposing this obligation in respect of open market dealings. We would draw attention to the fact that in paragraph 18 of our report, we did not refer to equality of price, but to ensuring that "so far as is practicable, each shareholder should have an equal opportunity to participate in the benefits offered."

11. It is also suggested that a collusive arrangement might be made for a seller to offer a parcel of shares in the market knowing that the offeror will buy them. As the memorandum points out, such an arrangement would contravene the proposed provisions. We would agree that it would be difficult to prove collusion, but the circumstances would almost inevitably arouse suspicion, since the sale must be a public one. The safer course for the parties would be to pay the increased price secretly, which would be almost impossible to detect. This means of evasion is, we think, unavoidable.

**Offers without cash alternative:**

12. We would also point out that the author of the memorandum concedes that the rule suggested cannot be applied to a case in which the offer does not have a cash alternative. It appears that this problem has been ignored in the U.K. and the U.S.A. It may well be asked on what principle an offeror who offers shares, or cash and shares, should be able to buy in the market without affecting the price paid to acceptors of the offer, while one who offers cash only must pay the increased price to all. In this difficult situation we favour the course which gives the acceptor no more than the amount he has accepted.

**Conclusion:**

13. It may be said that much of the reasoning in this paper tends to support the view that the early seller should never get an increased benefit. As we said in our report, there is much to be said for this approach. We do not support it as an absolute rule because we feel that it is generally recognised that where an offeror has announced his intention of making an offer to shareholders generally, it is unfair for him to offer a special inducement to a particular shareholder or group of shareholders. These considerations do not apply to stock market transactions, in which the market is available to everyone. In the light of our views as to the important function which the market performs while a takeover offer is current, and the desirability of freedom in that market, we recommend that the existing draft be adhered to.

14. We should add that we do not understand the comment made on page 5 of the memorandum under discussion, that "in a situation where a takeover offer is current a buying price above the formal bid cannot be anything but extraordinary (having regard to the fixed nature of the supply), and would only come from a buyer attempting to defeat the bid or the bidder himself". We see no reason to suppose that other bidders who regard the bid as too low might not enter the market in the hope of reselling at a profit, or because they think the bid is likely to fail, and regard the shares as undervalued in the long term. If, however, the contest is between persons attempting to defeat the bid and the bidder himself, it will be apparent from what we have said above that we do not think that the scales should be weighted any more heavily than they now are in favour of those who wish to retain control of companies whose performance is such as to encourage the making, of takeover offers

15. This memorandum has been prepared following upon discussion at a meeting of the Company Law Advisory Committee. Mr. Rodd has seen it and expressed his agreement. Mr. Cox concurs in the general conclusion, but owing to his absence overseas has not had an opportunity of considering the text of this memorandum.

R. M. EGGLESTON.

29th June 1970.