Guidance Note

RULE 20 AND COLLATERAL ARRANGEMENTS

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TAKEOVERS PANEL
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Contents

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This Guidance Note provides guidance regarding the operation of rule 20 which requires that a Code-regulated takeover offer must be made on the same terms and provide the same consideration for all securities belonging to the same class of equity securities under offer. This Guidance Note discusses rule 20 generally as well as addressing the issue of "collateral arrangements" in detail. A number of examples are used for illustrative purposes.

1 Introduction

1.1 A key feature of the Code is that a takeover offer must be made on the same terms and provide the same consideration for all securities belonging to the same class of equity securities under offer. This is set out in rule 20.

1.2 It is not unusual for an offeror, or an associate of an offeror, to enter into agreements or arrangements (**collateral arrangements**) with one or more target company equity security holders outside the formal offering documentation. A common example is the "*lock-up*" or "*pre-bid*" agreement, pursuant to which a target company shareholder agrees to accept a proposed offer in advance.[1]

1.3 The Code does not prohibit collateral arrangements per se. There may be legitimate commercial justifications for collateral arrangements. However, if the effect of the collateral arrangements is to provide terms or consideration to a target company shareholder under a takeover offer which differ from those offered to other shareholders those arrangements will breach rule 20.

1.4 The purpose of this note is to provide some guidance as to when collateral arrangements may have the effect of providing to some target company shareholders additional or different terms or consideration in breach of rule 20.

1.5 The Panel applies the following principles when considering whether a collateral arrangement may raise issues of compliance with rule 20.

1.6 Rule 20 requires that the takeover offer must be the same to all the shareholders within the same class. Compliance is not achieved if the terms of an offer as between shareholders of the same class are different (due to the collateral arrangements with some shareholders), even if the differences are (or may be) compensated for on an analysis of the value of those differences. Rule 20 will have been breached because the offer must be on the same terms to all shareholders in the class. Accordingly, the question is whether a collateral arrangement is part of the takeover offer.

1.7 Determining whether the collateral arrangement is part of the takeover offer involves the Panel making an inquiry into the substance of the collateral arrangement. It is common for an offeror to enter into arrangements with parties, who are also target company shareholders, for reasons to do with the future of the target entity once acquired. These could include, for example, assistance with transition, know-how transfer, incentivisation, etc.

1.8 Compliance with rule 20 is a substance over form test. Collateral arrangements may channel takeover consideration to a shareholder by means of a separate contract where there is no real rationale for the separate contract. In cases of fraud, lack of good faith, unreasonableness and the like the Panel may go behind the collateral arrangement to see whether, in reality, it is part of the offer and therefore in breach of rule 20.

1.9 If the Panel considers there to be any appreciable possibility that a collateral arrangement could be other than what it purports to be, and may involve non-compliance with rule 20 of the Code, the Panel may convene a meeting under section 32 of the Takeovers Act 1993 to consider whether to exercise its enforcement powers.

1.10 To help illustrate the issues, some cases that have been considered by the Panel are set out below.

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[1] See the *Guidance Note on Lock-up Agreements.*

2 Examples

Lowe Corporation Limited / Blue Sky Meats (N.Z.) Limited

2.1 In late 2002, Lowe Corporation Limited (**Lowe**) made a takeover offer for Blue Sky Meats (N.Z.) Limited (**Blue Sky**). Horizon Meats New Zealand Limited (**Horizon**) was a 37% shareholder in Blue Sky and held an exclusive marketing contract with the company.

2.2 Lowe and Horizon entered into a pre-bid agreement under which Horizon agreed to accept Lowe's takeover offer and Lowe agreed to get Blue Sky to cancel an exclusive marketing contract, for a payment of $2.7 million to Horizon, if Lowe's offer succeeded.

2.3 The independent adviser appointed to opine on the merits of the takeover (**the rule 21 adviser**) opined in its report that if the $2.7 million overcompensated Horizon for cancellation of the marketing contract, Horizon could be receiving additional consideration under the offer. However, the adviser stated in its report that it did not have sufficient information to verify whether the $2.7 million represented fair value for cancellation of the contract. The directors of Blue Sky, who opposed the takeover, said in the target company statement that one shareholder may be receiving additional consideration for its shares, which was different from other shareholders. This was tantamount to the directors saying that the offer breached rule 20 of the Code.

2.4 The Panel was therefore concerned that Lowe's offer may have breached rule 20 and decided to hold a meeting under section 32 of the Takeovers Act to determine the matter. The Panel retained its own independent expert to assist in its deliberations.

2.5 The expert opined that the $2.7 million would represent fair value for the cancellation of the marketing contract. Accordingly, the Panel was satisfied that there was no breach of rule 20 in that case.

Aged Care Services New Zealand Holdings Limited / Guardian Healthcare Services Limited

2.6 In late 2004, Aged Care Services New Zealand Holdings Limited (**Aged Care**), the acquisition vehicle of Pacific Equity Partners, successfully completed a takeover for 100% of Guardian Healthcare Services Limited (**Guardian**) for $176.2 million.

2.7 Prior to the offer, Aged Care had entered into lock-up agreements for about 40% of the voting securities of Guardian. Some of those lock-up agreements were with senior executives in Guardian who were also shareholders. Those arrangements provided for equity in Aged Care to be issued to those senior executives as a performance incentive.

2.8 These arrangements raised questions under rule 20 because the executives were also shareholders in Guardian. The rule 21 adviser opined that there were no rule 20 issues arising. The Panel decided not to take the matter any further.

Bacardi New Zealand Holdings Limited / 42Below Limited

2.9 In late 2006, Bacardi New Zealand Holdings Limited (**Bacardi**) made a takeover offer for 42Below Limited (**42Below**). Panache International LLC (**Panache**) was an option holder in 42Below and also held a distribution contract with the company. The two owners of Panache also held options and shares in 42Below.

2.10 42Below and Panache agreed during the course of the takeover that, after successful completion of Bacardi's offer, the distribution agreement would be terminated (with payment of a termination fee).

2.11 To address concerns about the compliance of the termination fee with rule 20, the 42Below directors asked the rule 21 adviser to opine on the issue in its report. The rule 21 adviser opined that the termination fee fell within its assessed value range for the distribution agreement.

2.12 The Panel noted that the opinion of the rule 21 adviser did not necessarily mean that Bacardi's offer complied with rule 20 of the Code. That was a matter for the Panel to determine. However, the Panel considered that in light of

the rule 21 adviser's opinion it would not take any further action unless it received a complaint or unless further information came to light that challenged the rule 21 adviser's opinion.

2.13 In addition to the Panache issue, another company, 420 Spring Water Limited (**420 Spring Water**), also was involved in a collateral arrangement. The majority of shares in 420 Spring Water were owned by 42Below. 42Below entered into an agreement with the other shareholders in 420 Spring Water under which 42Below was granted an option to purchase the shares in 420 Spring Water that it did not already own. The outstanding shares in 420 Spring Water were owned by persons who also owned shares in 42Below. The option agreement was conditional on Bacardi's takeover offer for 42Below becoming unconditional. The purchase price under the option agreement raised concerns under rule 20. The Panel asked the rule 21 adviser to opine on the issue. The rule 21 adviser report stated that the option was negotiated on an arms-length basis and that the adviser was satisfied that it did not confer any additional consideration to the minority shareholders in 420 Spring Water in respect of the Bacardi takeover offer.

HT Media Limited / Canwest MediaWorks (NZ) Limited

2.14 In mid-2007 HTMedia Limited (**HTMedia**) made a takeover offer for Canwest MediaWorks (NZ) Limited (**MediaWorks**).

2.15 MediaWorks' directors and senior officers held shares or options in MediaWorks. Some of those directors and senior officers entered into arrangements with HT Media's parent company, HTMedia Holdings Limited (**HTHoldings**), under which they agreed to accept HTMedia's offer and invest in the equity of HTHoldings following successful completion of the offer. HTHoldings agreed to fund part of that investment through loans to trusts associated with those directors and senior officers, repayable on the sale of the equity investment.

2.16 The Panel was concerned that these arrangements may not have complied with rule 20 and asked the rule 21 adviser to opine on the issue in its report. The rule 21 adviser considered that such arrangements were common in private equity transactions such as HTMedia's takeover offer, as a method of incentivising management and did not in this case represent additional consideration being offered to those directors and senior executives. The matter was not taken any further.

Simplot Mr Chips Limited / Mr Chips Holdings Limited

2.17 In mid-2008 Simplot Mr Chips Limited (**Simplot**) made a takeover offer for Mr Chips Holdings Limited (**Mr Chips**).

2.18 A number of directors and senior officers and major suppliers of Mr Chips (representing almost 82% of Mr Chips) entered into arrangements with Simplot and its parent company Simplot Australia Pty Limited (**SAPL**) under which they agreed to accept Simplot's offer and, following successful completion of the offer, to subscribe for equity in Simplot.

2.19 Another Mr Chips shareholder complained that these arrangements breached rule 20 because they gave the parties an opportunity to reinvest in the Mr Chips business; an opportunity which was not available to other shareholders.

2.20 The rule 21 adviser opined that the arrangements with the shareholders did not confer any additional benefits to those parties as shareholders in Mr Chips. One factor that the adviser viewed as important in its analysis was that the shareholders would not be investing in the equity of Simplot in proportion to their shareholding levels in Mr Chips. The largest of the shareholders was in fact investing in only a very small proportion of the equity of Simplot. Accordingly, that shareholder was effectively exiting for cash on a similar basis to other Mr Chips shareholders.

2.21 The Panel considered the complaint and engaged external counsel. The Panel considered that the terms of the arrangements with the shareholders would be terms of the takeover offer to the extent that the benefits provided under those arrangements were at undervalue. After reviewing the relevant documentation the Panel considered that there was insufficient evidence to conclude that the arrangements with the shareholders were at undervalue and decided not to pursue the matter.

2.22 Mr Chips also entered into "service agreements" with two companies that were associated with the Chairman and the CEO of the company (referred to above) who had also entered agreements with Simplot. Under the service agreements, Mr Chips would pay fees for the work undertaken by the Chairman and CEO in negotiating the takeover terms with Simplot. The fees were linked to the eventual offer price and were payable on the offer becoming unconditional. The independent adviser noted that the level of fees was high, but said that the service agreements had been disclosed to the board early in the negotiation of the takeover, and that the high price reflected Mr Chips' initially low expectations of the takeover price.

2.23 Mr Chips also paid an additional "loyalty incentive payment" to the CEO. The rule 21 adviser considered that this benefit was attributable to the CEO as CEO and not as a shareholder because such payments were a common feature of takeover offers and were designed to compensate the CEO for the additional work required to keep management stable during the disruption caused by the takeover offer.

Dairy Trust Limited / Open Country Cheese Limited

2.24 In 2008 Dairy Trust Limited (**Dairy Trust**) held 52.4% of the shares in Open Country Cheese Limited (**OCC**), a Code company. Olam International Limited (**Olam**), held 19.9% of the shares in OCC.

2.25 Olam and Dairy Trust entered into a "subscription agreement" under which Olam would subscribe for new shares of Dairy Trust for $78.6 million. Olam would then have the right to appoint two directors to the Dairy Trust board and would also hold a first right of refusal over a percentage of Dairy Trust's production output for five years. Dairy Trust agreed to use part of the subscription price to make a takeover offer for OCC.

2.26 The subscription agreement was conditional on Olam and Dairy Trust entering into a pre-bid agreement. Olam and Dairy Trust entered into this pre-bid agreement, under which Dairy Trust agreed to make a full takeover offer for OCC and Olam agreed to accept that offer for its entire 19.9% shareholding. In accordance with this agreement, Dairy Trust made a takeover offer for OCC and Olam accepted that offer.

2.27 The benefits accruing to Olam under the subscription agreement, being the right to appoint two directors to the Dairy Trust board and the first right of refusal over a percentage of Dairy Trust's production output for five years, raised questions under rule 20.

2.28 The rule 21 adviser report opined that Olam was not receiving any additional consideration for its acceptance of the offer because:

(a) the first right of refusal was more directly related to Olam's subscription for Dairy Trust shares. The subscription price for those shares was reasonable;

(b) the first right of refusal conferred advantages on both parties. Olam would be paying arm's length commercial prices for product and was therefore not extracting any premium from the supply agreement; and

(c) supply agreements of this nature were commonplace in the industry.

2.29 On that basis, the Panel considered that there was no appreciable possibility that the benefits accruing to Olam under the subscription agreement constituted consideration for its acceptance of Dairy Trust's offer in breach of rule 20.

New Image Trustee Limited / New Image Group Limited

2.30 In early 2013, New Image Trustee Limited (**NIT**) made a full offer for all of the shares in New Image Group Limited (**New Image**). NIT was controlled by New Image's Chairman.

2.31 On 13 and 14 March 2013, NIT sent a communication to a small number of New Image shareholders (all of whom had a historical business relationship with New Image's Chairman and the New Image business through being either employees or distributors of New Image products) offering an opportunity to acquire shares in NIT from the current owner of its shares, once the offer was completed (the **separate offer**).

2.32 The Panel considered that there was an appreciable possibility that the separate offer was part of the New Image offer and breached rule 20 of the Code, and found the following facts were relevant:

(a) rule 20 would be breached if an offer were made on different terms or different consideration was provided;

(b) the separate offer required New Image shareholders to agree to place their sale proceeds from their New Image shares into an account to be held on trust pending the issue of NIT shares (in contrast to the acceptance terms offered to all New Image shareholders);

(c) the separate offer was not made prior to the New Image offer when the rule 21 independent adviser would have had a chance to opine on the value of the NIT offer; and

(d) the separate offer specified that accepting shareholders were being offered exactly the same share percentage in NIT as they then held in New Image. If the offer to reinvest in NIT was being made for a bona fide commercial reason (other than as part of the offer for New Image shares) then the NIT share allocations would have reflected the value or significance of those commercial relationships rather than reflecting the New Image shareholdings.

2.33 NIT provided an enforceable undertaking to the Panel to withdraw the separate offer and made an announcement to the market to this effect on the circumstances which gave rise to the undertaking and the opportunity to withdraw. NIT contacted the recipients of the separate offer including those who have already accepted the offer and withdrew the opportunity. Following this, the Panel elected not to take the matter any further.

3 Conclusion

3.1 Rule 20 provides that an offer must be made on the same terms and provide the same consideration for all securities of the same class. This rule is fundamental to the Code.

3.2 However, it is possible to have arrangements with some, but not all shareholders, if these arrangements are not part of the offer. For example:

(a) If fair value is paid to a shareholder to relinquish a valuable commercial right;

(b) if securities are offered with the intention of incentivising key executives to remain with the company after a takeover offer is completed on terms consistent with standard market practice for the issuance of securities under key executive incentivisation schemes; or

(c) if other commercial arm's length reasons exist for the arrangements.

3.3 The Panel expects the rule 21 report to include the adviser's opinion as to the value and terms of the collateral arrangements.

3.4 The Panel will also examine collateral arrangements closely. If there is an appreciable possibility that the arrangements will breach rule 20, the Panel may call a section 32 meeting to decide the matter. This threshold to call a meeting is appropriately low, given the fundamental nature of rule 20.

3.5 The question of whether collateral arrangements comply with rule 20 is a matter of fact in each case. The Panel will consider substance over form when determining whether collateral arrangements in fact breach rule 20.