WEIL GOTSHAL

Private Equity Alert

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- Weil Gotshal advised Earthbound Farms (a portfolio company of HM Capital) on its acquisition of Mission Organics
- Weil Gotshal advised Castle Hill Funds (and its managers) on their spin-off from Ignis Investment Managers

UK Takeover Code Makes Changes Related to Management Incentives

By Ian Hamilton (ian.hamilton@weil.com)

On January 25, 2010 changes to the UK Takeover Code came into effect which affect the treatment and disclosure of management incentive arrangements on UK take privates, increasing the need for disclosure of management arrangements and requiring private equity houses to take greater care over any early stage discussions with incumbent management teams. The new rules introduced a new requirement into take privates: disclosure/approval of arrangements where discussions have reached an advanced stage, not only of concluded arrangements.

The previous provisions

The Takeover Code generally prohibited special deals with some shareholders which were not available to all shareholders. However, an exception existed for management retaining an interest in the target business.

Note 4 to Rule 16 of the Takeover Code allowed special deals with management shareholders, provided that:

- the target's independent financial adviser (the ***Rule 3 adviser***) publicly stated that the arrangements were fair and reasonable; and
- where the management would remain "financially involved" in the business (typically, by taking an equity interest in the bidder or in its holding company), the proposals were approved at a meeting of independent shareholders.

In addition, Rule 24.5 of the Takeover Code required details of all agreements, arrangements or understandings between a bidder and any directors, recent directors, shareholders or recent shareholders of the target having any connection with the offer to be disclosed, resulting in the disclosure in the takeover documentation of the key terms of management's arrangements.

The new provisions

A new Rule 16.2 has replaced Note 4 to Rule 16 and states the following:

- Where a bidder has entered into, *or reached an advanced stage of discussions on proposals to enter into*, any form of incentivization arrangements with management who are interested (including through options) in the target's shares: (a) relevant details must be disclosed in the offer document and (b) the Rule 3 adviser must publicly opine that the arrangements are fair and reasonable.

- If it is intended to put incentivization arrangements in place following the offer, but either no discussions or only limited discussions have taken place, this fact must be stated publicly and relevant details of the discussions disclosed.
- Where the value of the arrangements is *significant* and/or the nature of the arrangements is *unusual* (either in the context of the relevant industry or good practice), the Takeover Panel must be consulted and its consent obtained to the arrangements. The Takeover Panel may require independent shareholder approval to be obtained at a general meeting of the target as a condition to its consent.

The changes to the Code require private equity houses to take greater care over any early stage discussions with incumbent management teams.

- Where management are shareholders in the target and, as a result of the incentivization arrangements, will become shareholders in the bidder or its parent, such arrangements must be approved by independent shareholders. However, shareholder approval will not normally be required for an offer made to all holders of share options over the target's shares (for example, an offer to exchange their existing options for options in the bidder's share schemes), even where those holders include members of management.
- Where incentivization arrangements are put in place or amended following the offer document being published, the Takeover Panel must be consulted. The Takeover Panel may then require that all the above provisions are followed in relation to those arrangements.

Implications

The principal implications for private equity bidders in take privates are:

- A Rule 3 adviser's "fair and reasonable" opinion will now be required not only where agreement with management of the target has been reached, but also where discussions have reached an "*advanced stage*". In most usual take private situations this will not be a significant change as, typically, all management equity and other incentivization arrangements will have been agreed and documented by the time of any announcement of an offer. However, care will have to be taken to include other potential participants outside the immediate senior management team if discussions with them have been progressed sufficiently.
- Under the previous regime it was possible to have preliminary, high level discussions with management about their incentive packages without any disclosure or shareholder approval, provided that those discussions did not give rise to an agreement, arrangement or understanding with management. Under the new regime it is uncertain how the Takeover Panel will interpret "*advanced stage of discussions*", but that could include discussions even where no agreement, arrangement or understanding has been reached. Accordingly, bidders should assume that any meaningful discussions with management in relation to incentivization arrangements will need to be disclosed and, if they involve a rollover into the bidder's equity structure, approved by independent shareholders.
- The new provisions will continue to apply only to management who are interested in the shares in the target (including through options). However, the Takeover Panel must be consulted in relation to proposals which are "*significant*" or "*unusual*" which are to be entered into with members of management who are not interested in the target's shares.
- Takeover Panel consultation will only be required where arrangements are "*significant*" or "*unusual*", which ought to lead to fewer consultations with the Takeover Panel. (Previously, the Takeover Panel had to be consulted in all circumstances where management shareholders were being incentivized). An example of when the Takeover Panel may need to be consulted would be a proposal that a non-core member of the management team receives a significant equity stake in the bidder. The interpretation of the words "*significant*" and "*unusual*" will fall primarily to Rule 3 advisers, who will almost certainly err on the cautious side until the Takeover Panel's approach becomes clear.
- Where arrangements are "*significant*" or "*unusual*", the Takeover Panel may require independent shareholder approval. This is in addition to the previous (retained) requirement for shareholder approval where the arrangements are "financial" in nature.

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