

The Future of Takeover Regulation and Corporate Governance in the UK

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On 19 April 2017, British Prime Minister Theresa May surprised the country by calling a snap general election for 8 June 2017. While much of the discourse relating to the election is focused on Brexit and normal political issues relating to the management of the economy and public services, the topics of government control over cross-border takeovers and corporate governance reform are coming increasingly into the political spotlight.

The Conservative Party's recently published manifesto for the general election (the Conservative Manifesto) provides a glimpse of what can be anticipated for foreign takeovers of UK targets and UK corporate governance post-Brexit. The Conservative Manifesto focuses on potential changes to the UK Takeover Code, which governs public takeovers, and increased powers for governmental scrutiny in takeover bids. Corporate governance reform has already featured as part of Prime Minister May's commitment to "responsible capitalism" and increasing public trust in businesses; a government consultation paper published in November 2016 (the Green Paper) sought views on how best to update the current corporate governance framework, and on 30 March 2017, the Business, Energy and Industrial Strategy Committee of the House of Commons published a report setting out its perspective on the future of corporate governance. A number of reform options in the Green Paper were included as proposals in the Conservative Manifesto.

While recent experience cautions against placing too much confidence in opinion polls, given the Conservative Party's current polling lead over the other main political parties, this update focuses on relevant proposals contained in the Conservative Manifesto. However, proposals for reform of takeovers and corporate governance were also included in the election manifestos recently published by the Labour and the Liberal Democrat parties and therefore these are also mentioned below.

Takeover Reforms

The Conservative Manifesto proposes to make potentially significant reforms to the rules that govern takeovers and mergers in the UK. Noting that any changes will require careful deliberation, it proposes to require bidders to be clear about their intentions from the outset of the bid process and to require that all promises and undertakings made in the course of a takeover bid are legally enforced afterwards. The UK Takeover Code (the Code) already includes provisions requiring bidders to explain the long-term commercial justification for an offer and its intentions in a number of areas, including the future business of the target company and repercussions on employees. In addition, as a result of changes to the Code following Kraft's bid for Cadbury, undertakings given by bidders are binding and legally enforceable. In fact, the Takeover Panel has now begun to operate a mechanism deployed by anti-trust regulators to appoint third-party supervisors to monitor the progress towards, and ultimate achievement of, such undertakings. This has been done, for example with respect to Softbank's undertakings relating to ARM, the first big deal announced following the Brexit vote in June 2016. It is therefore unclear what further change will be proposed in this area — and whether it is intended simply to reaffirm the recent changes introduced by the Takeover Panel or to put these on some further statutory basis requiring new legislation.

Increased powers for governmental scrutiny of takeover bids also are proposed in the Conservative Manifesto. The Conservatives have said that they will ensure that the government can require a bid to be paused to allow greater scrutiny; however, there is no specificity as to how this "pause" will fit in with the UK Takeover Panel's powers for administering takeovers, what the "pause" would entail in practice or what form this further scrutiny would take.

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The UK Takeover Code already provides that a bid lapses if it is referred for phase 2 review by the UK Competition and Markets Authority (CMA) or the European Commission; once cleared, the bidder has 21 days to reinstate the bid on its original terms. One could imagine this structure being reviewed and adapted to accommodate any additional governmental review requirement — which would be likely to focus on any factors other than anti-trust deemed to be relevant and undertaken by the UK Department for Business, Energy and Industrial Strategy, over and above any review by the CMA or the European Commission into the anti-trust aspects. Such a review might lead the Takeover Panel to reconsider whether bids should lapse in the event of a phase 2 review by the European Commission post-Brexit, on the basis that the Takeover Code does not make similar provisions for comparable reviews in other jurisdiction outside of the UK. A second aspect of the Takeover Code's exceptional treatment of UK and European anti-trust is the fact that the Takeover Code's high materiality threshold does not currently apply to the invocation of offer conditions relating to approvals from the CMA or the European Commission. Given the Takeover Code's general bias towards compelling a bidder to implement its offer once announced, we expect the Takeover Panel to reconsider whether this materiality threshold should apply to offer conditions relating to approvals by the European Commission, and possibly also to approvals from the CMA.

Supplemental powers also would be given to the Pensions Regulator to strengthen its ability to scrutinise, clear with conditions or stop mergers, takeovers or large financial commitments that threaten the solvency of a pension scheme. The Pensions Regulator would also be able to issue punitive fines for those who have wilfully left a pension scheme under-resourced and, if necessary, disqualify directors. There is also the possibility of introducing a new criminal offence for directors who deliberately or recklessly put the ability of the pension scheme to meet its obligations at risk.

Finally, the Conservative Manifesto proposes to strengthen ministerial scrutiny of foreign takeovers of companies that control “important infrastructure” in sectors such as telecommunications, defence and energy. The Conservative Manifesto indicated that such controls would be similar to the measures that the government has already taken in connection with foreign ownership of civil nuclear power. Presumably, this refers to the requirements the government imposed in relation to foreign investment in the Hinkley Point C nuclear power plant, so it may be instructive to consider what these requirements were.

When the government approved the £18 billion Hinkley project in autumn 2016, it did so with specific conditions and with a proposal to reform its approach to foreign investment in critical infrastructure. The Hinkley project was approved subject to the

condition that the government would be able to prevent the sale of EDF's controlling stake prior to completion of the project. In connection with the grant of approval, the government also said that it would reform the legal framework so that the government would take a special share in all future nuclear new build projects. This would ensure that significant stakes could not be sold without the government's knowledge or consent. Furthermore, the Office for Nuclear Regulation has been directed to require notice from developers and operators of nuclear sites of any changes of ownership or part-ownership. This change was intended to allow the government to take action to protect national security in the event of a proposed ownership change. The final proposed change was that the government would reform its approach to the ownership and control of critical infrastructure so that the implications of foreign investment on national security could be scrutinised. This would include a review of the public interest regime in the Enterprise Act 2002 and the introduction of a national security requirement for government approval of the ownership and control of critical infrastructure.

The introduction of similar requirements for takeovers of companies in other sectors would represent significant change in the UK's approach towards cross-border transactions. It will be interesting to see what sectors, if any, will be included in the category of “critical national infrastructure” in addition to the three areas specified in the Conservative Manifesto. Other areas could include pharmaceuticals and technology, which have previously been highlighted by Prime Minister May as potentially requiring protection. After the proposed acquisition of AstraZeneca by Pfizer in May 2014, the government explored whether the impact of overseas takeovers on research and development in the UK should be taken into account in a public interest test, although no decision was ultimately made at the time.

Labour Party Proposals

The Labour Party has committed to amending the takeover regime so that businesses that are determined to be “systemically important” have a plan in place to protect workers and pensioners when a company is taken over. No further guidance was included in the manifesto on what “systemically important” means or on what the proposed amendments would cover.

Corporate Governance

Executive Pay

The Conservative Manifesto contains a number of proposals around corporate governance reform to deliver “fairer corporate governance, built on new rules for takeovers, executive pay and worker representation on company boards”.

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With respect to executive pay, the Conservative Manifesto proposes that a Conservative government would introduce new legislation to make executive pay packages for listed companies subject to a strict annual vote by shareholders. The Conservative Manifesto does not provide any further information on what “strict” would mean in practice, so it is unclear if this would be an annual binding vote on the executive pay package, as suggested in the Green Paper, an increase in the voting threshold for approval from a simple majority, or something else entirely.

Transparency in executive pay also featured in the Conservative Manifesto with a promise to require listed companies to publish the ratio of executive pay to broader UK workforce pay and for listed companies to improve the explanation of their pay policies, focusing particularly on complex incentive schemes. The Conservative Manifesto does not specify which ratio would be used or what form the new pay policy explanation would take.

Finally, the Conservative Manifesto promises to commission an examination of the use of share buybacks to ensure they are not being used artificially to hit performance targets and inflate executive pay.

Employee Representation

Before it was published, Prime Minister May promised that the Conservative Manifesto would include the “greatest extension of rights and protections for employees by any Conservative government in history”. To deliver on this promise, the Conservative Manifesto proposes that listed companies be required to either nominate a director from the workforce, create a formal employee advisory council or assign specific responsibility for employee representation to a designated non-executive director. These proposals are in line with the options included in the Green Paper and confirm that Prime Minister May has stepped back from the pledge she made in July 2016 to make it mandatory for company boards to include worker representatives.

The Conservative Manifesto also proposes the introduction of a right for employees to request information about the future direction of the company, although this would be “subject to suitable safeguards”.

Corporate Governance of Privately Owned Businesses

The proposals discussed above are focused on the governance of listed companies. However, the Conservative Manifesto promises to consult on how to strengthen the corporate governance of privately owned businesses. It is unclear how this consultation will differ from the Green Paper, which already included suggestions for the reform of the governance of larger private companies.

Labour Party and Liberal Democrat Party Manifestos

Executive pay also features in the Labour Party’s election manifesto, in which it proposes to impose a maximum pay ratio of 20:1 between the highest and lowest paid in the public sector and for companies bidding for public contracts. Labour also has proposed the introduction of an “excessive pay levy” on companies, which would require companies to pay a 2.5 percent charge on personal earnings above £330,000 and 5 percent on earnings above £500,000.

Currently directors of UK companies are required to act in a way that they consider, in good faith, would be most likely to promote the success of the company for its members as a whole and in doing so, they must have regard to the interests of other stakeholders, including employees, customers and suppliers, as well as the broader community and the environment. The Labour Party promises to amend company law so that directors owe a duty directly to shareholders and also to “employees, customers, the environment and the wider public” as opposed to merely having regard to their interests. This proposal would appear to be a very significant extension of the scope and liability spectrum of directors’ duties, although it is not clear how or by whom the new duties would be enforced.

The Labour manifesto also focuses on workers’ rights in the context of trade unions by proposing that a Labour government would guarantee trade unions a right to access work places and to enforce all worker’s rights to trade union representation at work “so that all workers can be supported when negotiating with their employer”.

Like the Conservative Manifesto, the Liberal Democrat manifesto includes proposals relating to executive pay, with their proposal being for larger employers to publish the ratio between top and median pay. The Liberal Democrats also committed to requiring a binding and public vote on executive pay policies.

On employee representation, the Liberal Democrats propose to include staff representation on remuneration committees and the right for employees of listed companies to be represented on the board. They also have said they will change the current company law to permit a German-style two-tier board structure to include employees, which is a departure from the traditional unitary board structure that is deeply engrained in the UK system.

The Liberal Democrats included additional items on corporate reform, including (i) giving employees in listed companies with more than 250 employees the right to request shares, to be held in trust for the benefit of employees; (ii) reforming fiduciary duties and company purpose rules to ensure that other considerations, such as employee welfare, environmental standards,

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community benefit and ethical practice, can be fully included in decisions made by directors and fund managers; and (iii) reducing the disclosure threshold for holdings in public companies from 3 percent to 1 percent.

Final Thoughts

Over the past few decades, the UK has gained a well-deserved reputation as a jurisdiction in which political and regulatory barriers to cross-border corporate transactions are relatively low. While the proposals in the Conservative Manifesto lack detail in some respects, they do indicate that, assuming a Conservative victory in the general election, the UK government may in future adopt a significantly more interventionist posture in its attitude to acquisitions of companies viewed as strategically important for the future British economy. The attitude of government has long been a relevant consideration when planning any material transaction and a critical factor in key infrastructure sectors;

the focus provided by the Conservative Manifesto on specified infrastructure sectors is helpful, but we will continue to assume a wider scope of potential political attention and an increased need to address government and political views as transactions are initiated.

However, as a balancing consideration the Conservative Manifesto does recognise that, without a strong economy, prosperity and security cannot be achieved, and therefore the promotion of industries with strategic value is key. Policies on corporate governance, trade, tax (including a 17 percent corporation tax), infrastructure, skills, training, and research and development will need to be geared to ensure that the UK is an attractive jurisdiction to establish and operate a business. Ultimately, the success of any Conservative government will be judged on its ability to balance these objectives and prepare Britain for success in a post-Brexit world.