Draft Policy Outline

Lock-up Devices

Summary

Lock-up devices are agreements intended to facilitate proposals for changes of control. They include such agreements as Break Fees, No-Shop and No-Talk Agreements, and some Pre-emptive Rights. They have become more common in Australia recently, although they have been well established overseas for some time. The Panel has considered the use of lock-up devices in Australia.

The Panel is concerned that lock-up devices be consistent with the "Fifth" Eggleston principle of an efficient competitive and informed market, and the original four Eggleston principles. They should not confer unequal benefits between shareholders. In particular, they should not be a material disincentive to the prospect of the emergence of a rival offer.

In determining whether a break fee arrangement is unacceptable, the Panel will consider whether it is consistent with those principles and is, in all the circumstances, reasonable.

For no-shop and no-talk agreements to be acceptable they must have a carve out allowing directors to fulfill their duties to target shareholders. No-talk agreements would be harder to justify than no-shop agreements and both would be harder to justify continuing in force once the bid has been announced.

The Panel considers that pre-emptive rights agreements on uncommercial terms ,which cover key assets, are triggered by changes of control, and are likely to affect an auction process adversely, would be unacceptable. An exception is where properly informed shareholders have approved the pre-emptive rights.

In this policy the Panel outlines the principles which it intends to apply in exercising its powers. It is not commenting on the legal validity or enforceability of particular arrangements.

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General Outline

1. In this Policy[1], the Panel indicates what lock-up devices it will find unacceptable in Australian takeovers. The Panel considers that lock-up devices is an area which is likely to evolve in Australia. The Panel will monitor the evolution, and its own experiences with lock-up devices, and will be very prepared to adjust and adapt this policy to keep it current and relevant.

2. Subject to certain principles concerning the objective and effect of the agreement and the amount of any fee, the Panel does not regard break fee arrangements and no-shop agreements as *prima facie* unacceptable.

3. In general, the Panel will not declare as unacceptable break fee agreements that permit the bidder to recover reasonable outgoings of the bidder to third parties and reasonable internal costs of the bidder.

[1] The Panel's Policy document will guide the Panel's administrative decision making in implementing the legislation and legislative policy.

There may be circumstances in which it is reasonable for the arrangement to extend to the reasonable and connected opportunity costs of the bidder.

4. Generally, it is good practice for the fee to be subject to a dollar or percentage cap. The amount of the cap should be appropriate to the circumstances. A cap of more than 1% of the bid value[2] would usually not be considered reasonable. This may be too low in the case of some small bids and unacceptably high in the case of very large bids. A cap will be more important where the costs included are materially harder to quantify (such as opportunity costs).

5. The Panel is more likely to find no-talk arrangements which continue to have effect once a bid has been announced, and pre-emption clauses on uncommercial terms and relating to key assets (depending on their timing and effect) to be unacceptable. However, all arrangements brought before the Panel will be considered individually, including when they were entered into and the circumstances of the company at that time.

6. Although lock-up devices are clearly becoming more common, the Panel does not consider that they should become a standard part of all takeovers in Australia, and believes that the obligations of target board directors to assess approaches for break fees, and other lock-up devices, against their duties as directors will ensure that this is not the case.

Types of Lock-Up Devices

7. In this Policy, we discuss the following types of lock-up devices:

Break Fees

8. Under a typical *break fee,* a fee is agreed to be paid to a party to a transaction if a specified event occurs which prevents the transaction from completing. In Australia, a break fee is usually agreed to be paid by a target to a bidder where:
   a. a higher competing offer is made by a third party (typically a rival bidder) under which the third party unconditionally acquires a majority of shares in the target; or

[2] The value used in calculating the cap is the total value of the class of securities bid for by the bidder, at the date of the announcement of the bid. We calculate it as the number of securities in the bid class multiplied by the value of the consideration being offered for a security in the bid class.

b. the target directors take action which causes the bidder's bid to fail (usually by promoting an alternative proposal or by triggering conditions to which the bid is subject).

9. However, a break fee can also be paid by a bidder. For example, a bidder may be willing to pay a break fee in return for a period of exclusive negotiations or a due diligence opportunity. In some cases the bidder and the target must each pay a fee in different circumstances.

10. Break fees may be agreed in relation to other transactions, such as an agreement between vendor and purchaser, or an agreement by a target if shareholder approval for an acquisition or a share placement is not given.

No-Shop and No-Talk Agreements

11. Under a *no-shop* agreement, a target agrees not to solicit an offer from a third party, usually during some defined period of exclusivity. Under a *no-talk* agreement the target board agrees not to negotiate with any other potential bidder, even if that bidder's approach to the target is unsolicited.

Pre-emptive Right Arrangements

12. *Pre-emptive right*[3] arrangements which concern this policy involve one party agreeing to provide preferential rights of some form to another party in specified circumstances. For example, an option to purchase key assets in the event of a change of control. Comments about pre-emptive rights apply with equal force to any major transaction triggered by a bid or a change of control.

Unacceptable Circumstances

13. The Panel's concern with lock-up devices is whether a lock-up device gives rise to unacceptable circumstances in the context of a particular bid or other transaction affecting control. Whether circumstances are unacceptable depends on their effect on shareholders and on the market, in the light of the policy of sections 602 and 657A of the Corporations Act (Act). It does not depend on the occurrence of unacceptable conduct or any intention to bring about an objectionable state of affairs.

[3] Pre-emptive right agreements where the effects are intended to deter a takeover bidder are often referred to as "Poison Pills". However, this definition includes some rights which are not strictly pre-emptive.

14. While conduct may give rise to unacceptable circumstances and also contravene the Act or the general law, not all contraventions give rise to unacceptable circumstances. For instance, if a breach does not give rise to a mischief of a kind relevant to section 602 of the Act, it may not lead to unacceptable circumstances.

Legality / Enforceability

15. The Panel is primarily concerned with the policy and principles of Chapter 6 of the Act. These are the principles of an efficient competitive and informed market and the Eggleston principles. However, it considers that parties should take their own legal advice on any arrangement. A lock-up device may be void or unenforceable because it contravenes the law relating to directors' duties, reductions of capital, related party transactions or in some other area.

16. The Panel would not wish to facilitate a lock-up device which appeared to be clearly invalid[4].

Competitive Market

17. A lock-up device is likely to lead to unacceptable circumstances where it inhibits the acquisition of control over a body taking place in an efficient, competitive and informed market. In general, the Panel considers that lock-up devices that inhibit an efficient auction process or have similar effects will be anti-competitive.

18. Each agreement will be assessed on its own merits in the particular circumstances. The Panel will generally not regard a lock-up device as unacceptable, if it is unlikely to impede competition for control of the target.

Break Fees

19. One reason for agreeing to a break fee is to provide an incentive to a bidder to undertake due diligence on a target or bid for it. It does so by transferring to the target (and to any over-bidder) the risk of bearing costs associated with the bid if the bid fails. Other reasons include helping to kick start an auction sale process, preventing a party from entertaining a competing proposal and ensuring that a party does not leave the negotiating table until the desired outcome is reached (for example, until a recommended offer has been negotiated).

[4] However, the fact that a Panel did not declare an agreement to be unacceptable would not affect its legality or enforceability.

20. Whether or not a break fee inhibits competition is a matter of fact and degree, to be judged on the facts of each particular case. On the one hand, a fee which helps to induce one person to bid against another may introduce or maintain competition. On the other hand, a fee so large as to make the target company worth markedly less to one bidder than to the other tends to stifle competition.

21. Where break fee agreements in other transactions relate to shares, for example agreements between vendor and purchaser, parties should be very careful to avoid any undue inducement or deterrent in the agreement which might give rise to a relevant interest in the shares by the prospective purchaser, or unacceptable circumstances by inhibiting any possible auction process.

No-Talk and No-Shop Clauses

22. An agreement not to seek out rival bidders, or even not to respond when a rival bidder seeks to initiate discussions, is of itself, directly anti-competitive, and target boards need to be convinced of the benefits to their shareholders before agreeing to them.

23. There may well be proper commercial, pro-competitive reasons why a target company board may consider these agreements for the period prior to a bid being announced. However, the acceptability threshold for justifying agreements which commence or continue once a bid has been announced rises markedly.

24. The period of such agreements is also one of the factors which the Panel will weigh when considering their acceptability. Relatively short periods to allow a prospective bidder to undertake due diligence prior to announcing a bid may be acceptable, but long periods (extending into months) are more likely to be found unacceptable.

25. In every case, it is highly relevant whether there is any prospect of a competing bid and whether the target company or its advisers has tested the market for possible rival bidders. What is acceptable if the bidder is likely to be the only suitor may not be acceptable if there are likely competitors.

Pre-Emptive Rights

26. A pre-emptive right over a key asset on uncommercial terms, triggered by a change of control, may have much the same effect as a substantial lump sum break fee. For a target to grant such a right will usually inhibit competition to buy control of the target. There are some good commercial reasons to grant such rights: for instance, they are usual in joint ventures. In the absence of an appropriate commercial reason for

giving such a pre-emptive right, or informed shareholder approval, the grant may give rise to unacceptable circumstances.

27. The Panel considers that directors should normally consider taking material pre-emptive rights[5] to shareholders for prior approval, with clear disclosure of the possible anti-competitive effects of the right if it were approved.

Reasonable and Equal Access

28. Another way in which a lock-up device may lead to unacceptable circumstances is if it results in shareholders not having *reasonable* and *equal opportunities* to participate in *benefits* accruing to shareholders in connection with a control transaction. *Reasonable* means that holders have adequate time to consider, sell, vote etc, and are not exposed to pressure tactics, and *equality* means equal value, not identical dealing. The *opportunity* is often to participate directly, by selling their shares or units, but it can also be an opportunity to participate indirectly, by voting on a transaction. The *benefits* can be given directly or in collateral transactions, and need not take the straightforward form of a price for shares.

29. In this context, subsection 657A(3) of the Act requires the Panel to take into account the actions of directors of a target, including actions which contributed to a proposed acquisition not proceeding.

Reasonable Access

30. Shareholders may be denied reasonable access to benefits accruing under a bid, if directors make a decision that effectively limits their power to decide the ownership of the company. For instance, pre-emptive rights granted in favour of a third party over key assets exercisable in the event of a change of control (eg. a successful takeover by a third party) could prevent shareholders from making their own decision when and to whom to sell their shares.

31. A break fee may be unacceptable where its size puts pressure on shareholders to accept a bid or other control transaction.

Inequality

32. A break fee would be unacceptable if it were an unequal benefit given in a transaction collateral to a bid or other control transaction. Any attempt to disguise an inducement to an individual shareholder by an

[5] Those which may adversely affect competition for control, or potential control, of the company.

uncommercial break fee, whether via a genuine or a sham bid, would constitute unacceptable circumstances.

32. If the break fee exceeds any increase in benefits offered to shareholders overall, it may give rise to unacceptable circumstances.

Remedies

33. The Panel has a wide power to make orders (including remedial orders) under section 657D of the Act if it finds that a lock-up device gives rise to unacceptable circumstances. For instance, the Panel may cancel or declare voidable an agreement relating to a takeover bid, or a proposed takeover bid, or any other agreement in connection with the acquisition of securities.

34. The Panel's remedies are aimed at protecting the rights of target shareholders, and ensuring a takeover proceeds, as far as possible, in a way that it would have if the unacceptable circumstances hadn't occurred.

Policy

35. Whether a lock-up device gives rise to unacceptable circumstances will depend on all the circumstances of the case. Accordingly, this policy does not seek to provide rules which cover all kinds of arrangements, without exceptions.

Break Fees

36. Each break fee agreement will be assessed on its own merits. The Panel will generally not regard a break fee (or other lock-up device) as unacceptable, if it is, in all the circumstances, reasonable, and consistent with the Eggleston principles – in particular, if it is unlikely to impede competition for control of the target. Break fees must be negotiated on an arm's length basis.

Break Fees Where Transaction Fails

37. A fundamental principle is that break fees should not override shareholder wishes. There is a risk of this happening where a break fee is payable where the proposal is rejected by shareholders in the absence of any competitive rival proposal and in the absence of any material change in circumstances. The Panel is not totally opposed to a break fee being payable in these circumstances, or where the break fee is consistent with the preservation of a corporate opportunity such as an option fee. However the onus on target directors to assess the net

benefits to target shareholders of a break fee is higher in these circumstances.

38. A break fee where the amount payable is reduced in these circumstances is less likely to influence shareholders' decisions and is therefore less likely to be unacceptable. For example, this might occur where the break fee is reduced to include only third party expenses where there is no rival bid but shareholders don't accept, or they vote down, the proposed bid, but where a rival bid beats the proposal the full break fee is payable.

39. When considering what quantum is reasonable for a break fee, target directors should also consider what costs and expenses (if any) the target company is likely to have expended in advancing the proposal. Where the target company shares material costs, such as in making submissions to regulators, drafting shared documents, hiring experts or advisors, these might be set against any opportunity cost which the bidder might assert.

No-Shop, and No-Talk Agreements

40. No-shop and no-talk agreements frequently have substantially anti-competitive effects. These need to be overbalanced by advantages to offeree shareholders.

41. Bidders and targets can minimise the anti-competitive effects of no-shop and no-talk agreements by restricting them to the minimum period reasonably required by the bidder to assess the target and prepare its offer. The Panel would view with concern agreements that prevented directors of the target speaking with prospective rival bidders for months.

42. The Panel will place materially more weight on the anti-competitive effects of no-shop and no-talk agreements which have effect or continue once the bid has been announced. It considers that the anti-competitive effects are likely to outweigh any remaining commercial advantages to target shareholders of no-shop and no-talk agreements in inducing a bid once that bid has been announced.

43. The case against a no-shop agreement is less strong, if directors have:
    a) included provisions which give priority to their duties to target shareholders; and
    b) assessed the state of competition for the company; and possibly
    c) sought out the bid having considered other alternatives for the company.

Pre-emptive Rights[6]

44. Like no-talk agreements, pre-emptive right agreements frequently have materially anti-competitive effects. Their anti-competitive effects need to be outweighed by advantages to offeree shareholders. However, they are common and unexceptionable in many instances, for example in joint venture agreements.

45. When considering the acceptability of pre-emptive right agreements, issues that the Panel will consider include:
    a. whether the agreement and its terms were disclosed to the market at the time of the agreement;
    b. if not, whether they have since been disclosed in a timely manner;
    c. whether the agreement was made on terms which, at the time of the agreement, were clearly fair and commercial ; and
    d. whether target shareholders approved the agreement at the time the target company entered into it, or when the underlying assets had grown sufficiently large in proportion to the target company to affect the competitiveness of the market for the target company.

46. The existence and terms of material pre-emptive right arrangements entered into by listed entities must be clearly and fully disclosed to the market at the time the company enters into them. There will be cases where the assets covered by a previously immaterial pre-emptive rights agreement grow materially (to the extent of being Poison Pills for potential bidders). Companies should ensure that they disclose the existence and terms of these previously immaterial agreements in a clear and timely manner when the materiality of the underlying asset changes.

47. The method of determining the price at which pre-emptive rights can be exercised will be very important in determining whether they are acceptable. Pre-emptive rights entered into on uncommercial terms will usually be unacceptable.

48. The case against pre-emptive rights is also less strong if they only give the right to match a rival offer, or to negotiate with a successful purchaser for specific assets, rather than an outright right to purchase and at a pre-specified price.

[6] Consideration of lock up devices, especially pre-emptive rights, is likely to overlap into the Panel's policy on Frustrating Actions by directors. This policy should be read in conjunction with the Panel's decisions in Pinnacle 5 and 8, and any published policy on frustrating actions.

Relevant Factors

49. In relation to any lock-up device, the Panel will consider, in the particular circumstances, whether:

(a) any fee or pecuniary benefit consists only of reimbursement of:
(i) the reasonable third party outgoings;
(ii) the reasonable internal costs; and
(iii)in appropriate circumstances, the bidder's reasonable opportunity costs;
that are connected with the bid, or is a reasonable estimate of those costs and outgoings (see below);

(b) the fee has a clear dollar or percentage cap. In this regard a cap of 1% of the value of the bid is a reasonable guideline for bids. However, in low value bids the costs may reasonably exceed 1% and in many large bids a fee of 1% may be excessive. The Panel considers that a clear cap is more important in circumstances where the fee contains indeterminate costs (such as opportunity costs);

(c) the arrangement is fully disclosed in the relevant documentation (see below);

(d) the arrangement is entered into for the purpose, and likely to have the effect, of inducing the counterparty to make or persist with a bid for the target (or a comparable transaction);

(e) the arrangement does not tend to reduce competition in the market for control of the target company;

(f) the target board considers that it is in the best interests of shareholders to promote a bid;

(g) the target board considers that the bid which the break fee induces will offer shareholders exceptional value for their holdings;

(h) the arrangement does not adversely affect the amount or distribution of benefits accruing to shareholders in the target in connection with a takeover or similar transaction;

(i) the period for which the target board binds itself is reasonable;

(j) the target board is explicitly allowed to fulfill its obligations to its shareholders; and

(k) the target board's obligations under the agreement do not exclude consideration of a rival bid, or dealing with a rival bidder, particularly if the rival bid is on better terms.

Recovery of Reasonable Outgoings, Expenses and Opportunity Costs

50. Whether a break fee is reasonable depends on both the nature and the amount of the outgoings and costs to which it is directed. The test is how much the target board would prudently pay, having regard to its fiduciary obligations and to the situation of the company, to induce the bidder to make or persist with its bid.

51. Reimbursement of fees for legal and financial advice on the relevant transaction is acceptable, if the fees and their amounts are reasonable and it would have been reasonable for the bidder to incur them, even in the absence of the fee arrangement. It will help to demonstrate that the fees are reasonable if there are arrangements to limit them to what is reasonable in the circumstances, such as a dollar or percentage cap, and arbitration in the event of dispute.

52. Reimbursement of internal costs is acceptable on a similar basis, especially if they could reasonably have been paid to external advisors (e.g. for legal or financial advice).

53. Reimbursement of opportunity costs is a difficult area. Where they are accepted, they will only be acceptable in relation to the reasonable and connected opportunity costs to the bidder, and will not be acceptable where they are to reimburse profit expected on the proposed bid. The Panel recognises the difficulty in quantifying opportunity costs and does not necessarily expect parties to such agreements to do so. Rather, the allowance for opportunity costs should be included within the dollar or percentage amount to which the agreement is capped. Parties to a break fee should be able to justify the inclusion of opportunity costs where they form part of the agreement.

54. The Panel does not see any basis for reimbursement of success fees.

55. Fees which are penal in nature or amount, and windfall gains to the counterparty are less likely to be acceptable.

Caps on Break Fees

56. The Panel considers that it is good practice for target directors to negotiate a capped figure (dollar or percentage based) as the maximum fee payable when entering into break fee agreements. This is more important where amounts which are not readily quantified might be included (such as opportunity costs).

Cap Limits

57. The Panel has decided against adopting a fixed maximum acceptable fee. A fixed amount in dollars would make no allowance for the differences between the size and nature of transactions. A fixed percentage would produce fees which were too small in small transactions, and too large in large ones. The Panel considers that 1% of the value of the bid may be a useful guideline for many circumstances. However, it notes that 1% may be insufficient to cover the reasonable outgoings and costs in a small value bid, but may well be unacceptably high in a large value bid.

Effect on Competition

58. In assessing the effect of a break fee on competition for control of the target, the Panel will have regard to what bids were expected or likely at the time, whether the bids known or expected were reasonably regarded by the target board as inadequate, whether the target sought out other prospective bidders, who made the initial approach and the effect of the fee on the conduct of the counterparty and any other bidders.

Full Disclosure

59. The existence and nature of any lock-up device must be fully disclosed by announcement to ASX, wherever either party is listed, and in the bidder's statement and target's statement (or any other relevant document, such as an explanatory statement for a scheme of arrangement), as appropriate. The terms should be available as an attachment to an ASX notice or lodged with ASIC and incorporated by reference.

60. The directors of the target should explain in the target's statement (or other explanatory document) why they have entered into the agreement, having regard to its effect on competition.

Process

61. The Panel expects that if a break fee or other lock-up device comes before the Panel, directors will be able to evidence their decision making process in considering the relevant issues relating to lock-up devices (including any advice taken) and the evidence of the appropriateness of entering the arrangements.