



**Government Response to the Business,
Innovation and Skills
Committee's Report on "Mergers,
Acquisitions and Takeovers:
The Takeover of Cadbury by Kraft"**

Presented to Parliament by the Secretary of State for Business,
Innovation and Skills

By Command of Her Majesty

July 2010

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GOVERNMENT RESPONSE TO THE BUSINESS, INNOVATION AND SKILLS COMMITTEE'S REPORT ON "MERGERS, ACQUISITIONS AND TAKEOVERS: THE TAKEOVER OF CADBURY BY KRAFT"

The Government welcomes the report by the BIS Committee on issues relating to mergers, acquisitions and takeovers, together with its suggestion that the report should be seen as a starting point for a further exploration of wider corporate governance issues. The Government agrees about the importance of these issues to long term UK competitiveness, and looks forward to working closely with the Committee in addressing them.

This paper sets out the principles by which Government will be guided in this area, and the key issues which we will seek to address. Like the Committee, the Government welcomes the Takeover Panel's review of certain aspects of the regulation of takeover bids, and will set out its views more fully on these important issues in the light of the responses to that consultation.

Recommendation

The closure of the Somerdale factory

2. We believe that Kraft acted both irresponsibly and unwisely in making its original statement that it believed that it could keep Somerdale open. A company of Kraft's size and experience ought simply to have acted with better judgement. By making its announcement and the subsequent reversal Kraft has left itself open to the charge that either it was incompetent in its approach to the Somerdale factory or that it used a "cynical ploy" to cast a positive light on Kraft during its takeover of Cadbury. We can neither prove nor discount either conclusion. We are aware of speculation in the press that the Takeover Panel is examining this issue. We would expect this to be the case; such serious questions deserve the detailed scrutiny that only the Panel can give. (Paragraph 19)

Kraft's undertakings in respect of Cadbury

14. The Kraft takeover of Cadbury has been marred particularly by the controversy over the closure of Somerdale and has heightened the feelings of mistrust in which Kraft is held. Kraft now faces a significant challenge to restore its reputation in the United Kingdom. Our evidence from Kraft did, however, give some welcome clarity on Kraft's intentions for brand management, the Cadbury workforce and the many philanthropic activities for which Cadbury is rightly admired. These commitments – which have been personally endorsed in writing to us by Irene Rosenfeld – are now in the public domain, and therefore will be subject to close scrutiny over the next few years. If Kraft is serious about restoring its reputation in the United Kingdom, it is vital that it delivers on all of them. Any back-tracking from these commitments, or any evidence that support management and other functions, especially Cadbury's

world class Research and Development, are indeed being transferred to the United States would be a serious breach of trust. We recommend that the Department for Business, Innovation and Skills monitors Kraft's compliance to these commitments. If it is serious about them, Kraft will have nothing to fear from such scrutiny. (Paragraph 55)

Response

The Government will monitor Kraft's delivery of the commitments it has made and its conduct as the new owner of one of Britain's most historic and reputable companies, although the Government has limited powers to force Kraft to supply information and comply with these commitments.

It has also noted that the Takeover Panel has issued a statement of public criticism in connection with certain statements about Cadbury's Somerdale facility. The Government does not wish to comment on the circumstances of this particular case, but believes that it is very important that both bidding and target companies provide full information which has been properly checked and verified.

Recommendation

Short-termism in decision-making

15. We are deeply concerned by reports that the takeover of Cadbury by Kraft was ultimately decided by institutional investors motivated by short-term profits rather than those investors who had the company's long-term interests at heart. As a template for takeovers, this is not in the interest of UK companies or the UK economy. (Paragraph 62)

16. We welcome the Government's focus on the issue of 'short-termism' in decision-making on the future ownership of UK companies, and its efforts to engage with institutional fund managers as part of the process. However, we are sceptical about the extent to which informal engagement alone can instigate any fundamental change in institutional shareholder behaviour, in particular where there are financial incentives for fund managers and others to act in the short term. (Paragraph 63)

Response

The Government welcomes the Committee's comments on the issue of short-termism in decision making. It agrees that it is important that all key players in the management and ownership of UK quoted companies take a long term view, and that there is effective engagement between them.

Both company law and the corporate governance best practice framework emphasise the importance of considering the long term implications of business decisions. In particular:

- Under the Companies Act 2006 directors have a duty to have regard to the likely consequences of any decision in the long term in promoting the success of the company;
- The revised Corporate Governance Code published by the Financial Reporting Council on 28 May 2010 introduces the important principle that the performance-related elements of executive directors' remuneration should be designed to promote the long term success of the company.

It is important that company directors have long term strategic objectives which reflect a wider understanding of the environment in which the company operates and the principal risks and uncertainties which it faces. It is also important that the directors communicate these effectively to shareholders and investors so that there is a common understanding of the company's strategy, and investors can take a long term view of the company's prospects in meeting their own long term objectives.

The ownership of the UK's quoted companies has changed very significantly since the Takeover Panel was established in 1968:

- In 1969, individuals owned 47% of quoted company shares, with institutional investors owning 24% and foreign investors around 7%;
- By 2000, individuals owned less than 20% of shares, with the holdings of both UK institutional investors and foreign investors rising sharply to 44% and 36% respectively;
- The latest Office for National Statistics figures from December 2008 show that individuals now own only 10% of shares, with institutional investors holding 40% and foreign owners 41% of UK quoted company shares¹.

These changes, and developments associated with them, have important implications for the effective governance of our leading companies:

- The proportion of shares held by UK institutional shareholders has fallen over the last ten years, but they continue to have a powerful voice in the governance of UK quoted companies;
- The chain between the person with the economic interest and the individuals buying and selling shares, and voting on company resolutions, has become much more complex; in particular, most institutional shareholders, whether based in the UK or overseas, manage their assets through fund managers, who are often the key interlocutors with the company;

1 ONS Share Ownership Survey 2008

- The proportion of shares held by foreign investors, including overseas pension funds and sovereign wealth funds, continues to rise, but overseas investors at the moment play only a relatively small role in UK corporate governance;
- The market has become more liquid: the speed of change of ownership is much faster than thirty years ago, and new types of funds have entered the market, some such as hedge funds with a short term bias.

On 2 July 2010 the Financial Reporting Council published the first Stewardship Code for institutional investors. The Code includes principles on:

- The monitoring of investee companies;
- The escalation of activities taken to protect or enhance shareholder value;
- Collective engagement;
- Voting policy;
- Managing conflicts of interest; and
- Public reporting and reporting to clients.

The Government welcomes publication of this Code. It is essential that there is effective and constructive engagement between companies and their major shareholders with a view to promoting long term success, and the new Code is an important step towards achieving this. It will be important that both institutional shareholders and fund managers apply the Code's principles, and report publicly on how they have done so. The Government also welcomes the increasing involvement of overseas investors in the governance of UK quoted companies, and would like to see London become a centre of excellence for effective engagement between companies and shareholders.

Recommendation

Review of takeover regulations

17. We welcome the fact that the Government is considering a review of the rules and legislation governing takeovers in the United Kingdom. We also welcome the current consultation by the Takeover Panel on its City Code on Takeovers and Mergers. Such consideration of the underlying issues must not be seen as protectionism against foreign takeovers but as seeking to ensure that all takeover activity, whether entirely domestic or by foreign companies, is conducted in the interests of the UK economy. (Paragraph 69)

18. While we have not taken sufficient evidence at this stage to enable us to come to a view on the merits or otherwise of extending the powers of intervention by the Secretary of State, we strongly believe that this issue should be considered as part of the wider debate on takeover regulations. (Paragraph 75)

Response

The Government welcomes the conclusions of the Committee. We welcome all forms of investment in UK business, including by overseas investors, but want to ensure that investment decisions are made in the long term interests of UK companies and shareholders.

The Government's overall approach to the regulation of takeovers is based on the following principles.

- It is important that the UK continues to enjoy the benefits of open markets. The Government welcomes inward investment and draws no distinction between foreign or domestic ownership; at the same time, UK companies benefit from their ability to invest overseas.
- A company should be much more than a series of short term financial transactions, and its directors should have a clear strategic vision and sense of purpose.
- The owners of a company also have an important responsibility, not least during a takeover bid. Shareholders should consider bids carefully and seek to gauge long-term value, especially in the case of bids to take over strongly performing companies.
- The relationship between company owners and directors is of fundamental importance to good corporate governance. Where this relationship is strong:
 - There will be a shared vision of the company's strategy and objectives, reflected in the performance criteria for directors' remuneration;
 - Shareholders will receive high quality and timely information from the company, which reflects the information the directors use to manage the business;
 - Shareholders will not try to second guess the directors in their day-to-day management of the company, but will hold the directors to account for their stewardship of the company.
- Too many takeovers in the UK fail even by the limited criterion of shareholder value – and often with serious implications for the people who work for the firms on both sides.
- But that does not mean we should return to the old-fashioned public interest test, which encouraged weak managements to lobby for protection. The Government has no current plans to amend the legislation governing the power to intervene in mergers on public interest grounds. We are satisfied that the existing powers provide the appropriate scope to take action to protect legitimate national interests that might be affected as a result of a merger.

- Instead, we plan to review whether there are other aspects of the merger framework which could be tightened up, such as an increase in merger fees and a requirement for pre-notification of some mergers, as is done in most other European jurisdictions, in order to prevent some of the hasty deal-making (and the difficulties associated with breaking up mergers after the event).

The Takeover Panel's current review is playing an important part in addressing a large part of this agenda. The Government will publish a further paper on the regulation of takeovers in the light of the responses to the Panel's consultation. In doing so, it will wish to look in particular at three key areas:

i) Do bids make economic sense from the perspective of the bidder?

It is important that mergers and acquisitions are undertaken on an economically robust and rational basis to ensure that they provide long term benefits. The evidence suggests that many mergers and acquisitions are motivated less by economic value for shareholders and more by managers' own objectives and desire to increase company size².

At the same time it is clear that many of those involved in a takeover have a vested interest in the bid proceeding and being accepted:

- Bids are very valuable to advisers. In 2009, fees paid to advisers in the global M&A market were typically around 0.2% of total deal value with the top ten advisers each earning between \$500m and \$1billion³;
- Bids may also be very valuable to the directors of both the bidding company and the target company, either through direct benefits such as pay-offs or increases in the value of shareholdings or from the indirect career benefits.

The position of the shareholders of the bidding company is more equivocal. There is evidence that the net positive effects on shareholders are focused mainly on target companies, whilst bidder companies achieve small increases in value, or declines in the case of hostile takeovers⁴.

ii) Do target boards too often act as if their sole role is to get the highest price?

Under section 172 of the Companies Act 2006 directors have a duty to have regard to the likely consequences of any decision in the long term in promoting the success of the company. The interpretation of this statutory duty has become an important part of the debate about the role of the directors of target companies. The Government believes that it is important that target boards do consider carefully whether the bid would represent best

2 For example Klaus Gugler, Dennis Mueller and B. Burcin Yurtoglu "The determinants of merger waves" (Working Paper University of Vienna 2004)

3 Source: Thomson Reuters <http://in.reuters.com/article/idINN1717158820091218>

4 Martynova and Renneboog, "Mergers and Acquisitions in Europe" (2006), Tilburg University, Centre for Economic Research

value for their shareholders in the long term, particularly as evidence does not suggest that the targets of successful takeover bids had poorer pre-bid performance than other targets.

iii) Is the outcome of takeover bids decided by investors with short term time horizons?

While market liquidity is clearly very important, there have been suggestions that short-term volatility in a target company's shares may undermine any possibility of a target company fighting off a hostile bid. While it would be unfair to blame short term speculators for the outcome of takeover bids – the majority of shares will usually still be held by 'long term' institutional shareholders – it has been suggested that this can be a significant factor in some takeovers.

In addition, the Government welcomes the Takeover Panel's exploration of issues relating to the "put up or shut up" regime, "virtual bids" and the offer timetable.

Recommendation

Conclusion

19. The takeover of Cadbury by Kraft has highlighted a number of important issues in respect of the way in which foreign takeovers of UK companies are conducted. It has been the catalyst for a wider debate, both in Government and in the City, about how takeovers are conducted. In highlighting the Kraft takeover of Cadbury, we have contributed to that debate which now needs to continue, and with urgency. Time does not allow us to consider the wider proposals for reform in detail but it is clear that the Companies Act 2006 has not resolved these major issues in corporate governance. We urge our successor Committee to consider this Report as a starting point from which to conduct a detailed inquiry into these important issues and into the role of shareholders and managers of companies more generally. Recent experience of the behaviour of boards and shareholders in situations ranging from the fall of RBS to the Kraft acquisition of Cadbury indicate that it is time to reconsider many aspects of corporate governance. (Paragraph 76)

Response

The Government agrees that the way in which the UK's largest companies are managed and controlled is of major significance to UK competitiveness.

Much has been achieved in recent years. In particular:

- We have modern regulatory frameworks in company and competition law;
- Through the work of the Financial Reporting Council and earlier committees, we have a Corporate Governance Code which has formed the basis for best practice around the world;

- The Financial Reporting Council has recently published the world's first national Stewardship Code for institutional shareholders.

The Government will wish to look closely at issues relating to the regulation of takeovers in the light of responses to the Takeover Panel's current review. It will also want to look further at broader corporate governance issues, including:

- The way in which institutional shareholders and their fund managers perform their role as responsible owners of UK quoted companies;
- The ways in which we can strengthen engagement between quoted companies and their shareholders. One important aspect of this is the quality of company reporting, and the Government will shortly be consulting on how to improve the quality of narrative reporting.



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