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Preparing for the Public Takeover Bid: Duties and Options of the Board of Directors

The board of directors (the “Board”) of a Swiss publicly held company that is the target of a public takeover – especially if hostile – is unexpectedly confronted with a plethora of complex questions that must be answered quickly. The takeover battles against Saurer AG and SIG Holding AG are only the most recent examples in a wave of hostile takeover attempts in the last two years. Through early preparation the Board can lay the organizational and technical foundations for a takeover situation that will allow it not only to react but to provide active and timely leadership in the interest of the company. As part of strategic planning, the Board of a Swiss publicly held company also has to assess and decide whether – and if answered in the affirmative – which preventive measures including defensive actions are to be taken against an undesired public takeover bid.

1 Competence and obligations duties of the Board

1.1 Corporate strategy

The fundamental and non-transferable duty of the Board of a Swiss stock company is the ultimate management of the company (Art. 716a Swiss Code of Obligations). The ultimate management is a three-part responsibility consisting of determining the corporate strategy of the company, allocating the corporate resources to achieve the strategic goals and controlling the management bodies in pursuing the established goals. As part of strategic planning, the Board also has to examine whether, how and with which means the company as an independent entity can achieve the strategic goals. Among other steps, it must assess which actions, including possible defensive measures, are to be taken in view of a possible public takeover bid in order to ensure that the company strategy can be further pursued.

1.2 Assessment

As a basic question, the Board will evaluate whether the strategic goals of the company can best be achieved independently, whether a strategic cooperation with another company is needed or whether it even seems appropriate to offer the company or parts of it for sale to third parties or to the highest bidder (auction).

This decision obviously has far-reaching consequences for the future development of the company and for the question of whether and which measures seem appropriate for defending against a takeover. Is the company to achieve its strategic goals independently, the Board will be able to deliberate in advance about implementing suitable defensive measures to impede the success of an unsolicited takeover. The situation is different if the Board deems a takeover by another company to be the best option for the future of the company. A rolling assessment of the implemented measures and its adaptation to the actual situation is one of the duties of the Board.

1.3 Best interests of the company as the primary guideline

In its strategic assessment, the Board has to be guided by the best interests of the company. This flows from the Board’s fiduciary duty vis à vis the company. To date, however, there is no generally accepted definition of the best interests of a company, thus, each individual situation must be treated on a case by case basis. What is widely accepted, however, is the view that whatever safeguards the continued existence and the long-term prosperity of the company lies in the best interests of the company. A fundamental expression of the best interests of the company is the corporate strategy. In the forefront of a takeover bid, the company’s corporate strategy will be the Board’s primary criterion for its evaluation of the bid. Especially



after a specific takeover bid has been launched, however, the Board also has to give reasonable consideration to an optimization of the bid and of the takeover price in order to appropriately safeguard the interests of the shareholders.

2 Preventive measures with regard to a possible takeover bid

Experience shows that publicly held companies are often confronted unexpectedly with a takeover bid, thus taking the persons involved by surprise. Quite recently, for example, FERD A/S contacted the Board of SIG Holding AG on a Friday afternoon by presenting it with a non-binding confidential offer letter and requesting a response by Sunday afternoon to respond. In such cases the Board of the target company finds itself front and center, with limited time to consider the facts. The principles of good governance dictate that the Board takes suitable precautions in good time to allow it to concentrate on what is essential in the hectic phase of a takeover battle and to ensure that timely, informed decisions will be made in connection with the numerous complex questions. Starting as early as the pre-bid phase, these actions range, for example, from examination of the substance of the non-binding offer by the Board, through questions of insider relevance and fair disclosure (ad hoc publicity), particularly during performance of a due diligence review, to consideration of the principle of equal treatment under the applicable stock company and takeover laws.

In the normal course of business, i.e. before an initial approach by a potential acquirer, it is recommended that the Board take some preparatory measures, such as:

- | **Definition of the internal decision making process in the event of a takeover bid:** The competencies in the case of a takeover bid are to be clearly defined, especially between the Board and Senior Management, but also within each of these bodies. The Senior Management of the company will be greatly impacted by a takeover bid, but nevertheless must be able to manage the operative business. If the Board wants to accomplish its central mission, it must consider and take the measures that its members and/or any board members forming part of a particular executive committee to be possibly formed, must incessantly and immediately be available.
- | **Investor relations and early warning system:** Contacts and exchange of information with analysts, investors, competitors, etc. as well as regular market observation and market analysis not only, but also in view of identifying potential parties with takeover aspirations, will help minimize the surprise effect felt by the target company in the event of a takeover bid.
- | **Selection of and coordination with external specialists:** In order to be able to count on a ready team providing professional support without delay if a potential bidder approaches a target company, it is advisable to select specialized investor relations or corporate communications agencies, investment banks / M&A advisors as well as law firms and accounting firms in advance of takeover situations. Thanks to their experience in company takeovers, such specialists

can advise the corporate bodies, among others in the communications process, about the do's and don't's of the target company in the various stages of a public takeover, with regard to the valuation, fairness and processing of the bid as well as with regard to questions in the disclosure of financial key data.

- | **Evaluation of defensive measures to be implemented in the articles of incorporation or otherwise:** If the Board concludes on the basis of its assessment that measures of the company to defend against a takeover are required, it will take appropriate defensive measures (in this regard see below in Section 3).
- | **Review of the employment contracts of management:** As part of its compliance duty, the Board will ensure, among other things, that the company also satisfies the requirements under takeover law. In particular, change-of-control clauses in the employment contracts of management are to be examined for its enforceability in light of recent decisions of the Takeover Board and the Federal Banking Commission (especially in the case of Saia-Burgess Electronics). This means that even contractual clauses that do not trigger unusually high severance compensation in the event of a takeover could constitute inadmissible defensive measures if they disregard the best interests of the company and serve solely the interests of management, without adequate consideration being furnished in return.
- | **Rules of conduct for conflicts of interest:** Conflicts of interest are conceivable, for example, if there is a legal relationship between a member of the Board of the target company and the potential bidder. Therefore, conduct procedures regarding possible conflicts are to be provided, such as obligations to disclose potential conflicts of interest without delay, rules governing recusal, i.e. abstaining from participation in the deliberations and decisions of the Board, measures for handling insider information, possibly the formation of independent special committees, obtaining a fairness opinion from independent parties, etc. If conflicts of interest exist, it must be clearly evident, in the event that a bid is submitted, that the Board is disclosing, in its report, the measures that the target company has taken in order to ensure that these conflicts do not work to the disadvantage of the shareholders of the target company (Art. 31 para. 3 Takeover Ordinance / TOO).
- | **Warm-up / Training of the Board with regard to takeover situations:** In view of the fact that the Boards of Directors of target companies are frequently confronted without advance warning by a party with takeover aspirations (or directly with a takeover bid), it appears advisable that the Board anticipate this and make itself familiar with the mechanics of takeover bids and the main options for the response of the target company to potential bidders during the delicate pre-bid phase. One vehicle for doing so is further education of the Board along the lines of Best Practice for Corporate Governance.
- | **Identification of potential "white knights":** Legal regulations do not prevent a company from seeking out, as early as the

pre-bid phase, potential bidders that would in the event of a hostile takeover attempt be a good fit with the target company from a strategic viewpoint and that basically would be willing and able to submit a competitive bid (white knight).

3 Defensive measures

If the Board concludes, after careful consideration of interests during its assessment, that measures to defend against a takeover are required, several options are open to the target company – as long as a public takeover bid has not been made – in order to defend against or at least impede a hostile takeover bid.

3.1 Defensive measures to be implemented in the articles of incorporation

During the pre-bid phase, among other approaches, the articles of incorporation could be amended to provide for one or several of the following provisions:

- I **Restriction of transferability** (“*Vinkulierung*”): A traditional means that publicly held companies use to defend against an unwanted takeover is restriction of transferability of registered shares. The articles of incorporation can provide a percentage restriction of registered shares for entry of a shareholder in the stock register. In practice, thresholds of 2%, 3% or 5% of the share capital are quite common. A company cannot stop a shareholder from acquiring shares even beyond this threshold and benefiting from the dividend or other economic rights. But by declining the registration request, the Board of the company can prevent the shareholder from exercising the voting rights corresponding to its excess holding as well as the associated membership rights.
- I **Restriction of voting rights**: Even though each share confers one vote according to the “one share one vote” principle, the articles of incorporation can provide that a shareholder is entitled to exercise only a restricted number of votes of his own or of represented shares at the general meeting. Several Swiss publicly held companies have taken advantage of this option and restricted the voting right of individual shareholders to usually between 3% and 5% of the votes represented at a general meeting. Such a provision is even more effective when it also applies to shareholders that act in concert or as an organized group within the definition of disclosure law. Voting rights restrictions make it difficult for larger shareholders to push through certain amendments to the articles of incorporation or to force personnel changes in the Board.
- I **“Opting in”**: In principle, any shareholder that has acquired more than 33 1/3% of the voting rights of a company listed on a Swiss stock exchange has to submit a bid for all listed equity securities. In their articles of incorporation, companies are allowed to increase this threshold to 49% of the voting rights (known as “opting up”) or even to exclude it entirely (“opting out”). At present, approximately 22% of all Swiss companies listed on the SWX Swiss Exchange make use of “opting out” (none of them SMI corporations), while approximately 6% (including 2 SMI companies) have chosen

“opting up”. The Board of a company that has made use of one of these two possibilities may consider, as a preventive measure against an unwanted takeover attempt, to return to and apply the basic rule as provided by law by choosing to “opt in”. A company, thus, that has chosen “opting out” or “opting up” is more susceptible to a hostile takeover, since a large shareholder can assume control of the company at least de facto, without having to submit a bid to the minority shareholders.

- I **Staggered election of the Board**: Nowadays staggered election of the Board is standard in many publicly held companies. The purpose is to ensure a certain continuity and avoid the situation that the terms of office of the members of the Board expire simultaneously. Certainly the general meeting has the right to remove members of the Board; however, by stipulating a qualified majority for such a removal, the likelihood that a shareholder group critical of the Board might staff the Board largely with members agreeable to it can be limited. During ordinary re-elections, therefore, only one third of the incumbent members of the Board could be voted out by simple majority resolution in such a case.

In practice, however, the effect of such defensive measures is tempered to a relatively large extent, in that the bidder regularly makes its public takeover bid contingent upon prior repeal of the defensive provisions in the articles of incorporation and upon gaining control in the Board of the target company. If the shareholders of the target company deem the public takeover bid to be attractive in principle and thus decide to tender their shares, satisfaction of the corresponding terms and conditions of the bid therefore lies in their own interests, and the formal resolutions to be adopted for this purpose at a general meeting usually no longer represent an insurmountable hurdle.

Nevertheless, the cited defensive measures could be more solidly grounded if the company defines special majorities for amending certain provisions of the articles of incorporation. However, such quorum are rarely found in practice in publicly held companies.

3.2 Further preventive defensive measures

Besides the defensive measures anchored in the articles of incorporation, further possibilities of impeding an unwanted takeover attempt are available to a potential target company. For example:

- I **Shareholder structure**: If the Board knows a large proportion of its shareholders, it will be able to estimate to what extent the structure and composition of the shareholders will already impede a hostile takeover. For example, it is often seen that larger shareholders with a manifest strategic interest in the company can be persuaded to tender their shares in the case of a hostile takeover bid only – if at all – if the bid is significantly above average. On the other hand, examples from the recent past show that the launch of a takeover bid is frequently accompanied by a large shift in shareholder structure, in which traditional shareholders are replaced by professional market traders, especially hedge funds.



| **Pool contracts:** Furthermore, shareholders are allowed to enter into pool contracts with one another, forming alliances of voting rights that can be overcome only with difficulty by a hostile bidder. Of course, it must be noted that such shareholder pooling contracts are subject to the reporting obligation in connection with disclosure of shareholdings under the Stock Exchange Act.

3.3 Inadmissibility of defensive measures of the Board after the launch of a takeover bid

After a takeover bid has been published (or after a prior official announcement of this has been made [*Voranmeldung*]), and until publication of the outcome, the **Board** is not permitted to take **any** measures which could impermissibly forestall a bid or prevent it from being successful. Specifically, the Stock Exchange Act prohibits the Board, **after** publication of the bid until announcement of the result, from entering into legal transactions with which the assets or liabilities of the company would be significantly altered (Art. 29 para. 2 SESTA). According to the practice of the Takeover Board, however, measures directed at defense are reviewed also as to their compliance with company law, whether such measures are initiated in the pre-bid or the bid-phase.

In contrast, the **general meeting** of the target company is in principle not subjected to any restriction of its powers under takeover law. In the scope indicated here, there is even a shift of powers from the Board to the general meeting. Under certain circumstances, however, the offer conditions impose certain limits on the defensive measures of the general meeting.

In particular, the following measures of the Board are not permissible in the absence of a resolution of the general meeting (Art. 35 para. 2 of the Takeover Ordinance):

- | the sale or acquisition of the company's assets at a value or price of more than 10 per cent of the balance sheet total (on the basis of the latest annual or interim accounts, consolidated if appropriate) ("scorched earth");
- | the sale or pledge of any part of the company or its intangible assets that constitute the main subject matter of the offer and are designated as such by the offeror; ("crown jewels");
- | the conclusion of contracts with members of the Board or senior management providing for unusually high compensation payments in the event of their resignation from the company ("golden parachutes");
- | the issue of shares on the basis of the company's authorized capital without a pre-emptive subscription right for shareholders, insofar as the decision of the general meeting creating the authorized capital does not expressly provide for a share issue in the case of an offer. The same rule shall apply to the issue of bonds with conversion or option rights on the basis of contingent capital with no pre-emptive subscription right for shareholders.

For the stated reasons, it is of great importance for the Board of a publicly held company to evaluate possible preventive and defensive measures and if necessary to implement them in good time and before publication of a takeover bid.

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The content of this Newsletter does not constitute legal or tax advice and may not be relied upon as such. Should you seek advice with regard to your specific circumstances, please contact your Schellenberg Wittmer liaison or any of the following members of our Corporate/M&A team:

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