

## **The merger situation**

6.1. At the time the reference was made to us and throughout most of the inquiry there were two separate issues relating to the merger situation. These were (1) Lonrho's intention to bid for House of Fraser and (2) resolutions requisitioned by Lonrho concerning the composition of the House of Fraser Board and related matters. We summarise in this chapter the parties' views on these issues and on further developments.

### **The intention to bid**

6.2. Lonrho argued that its intention, when released from the 1981 undertakings, to make a bid for all the shares in House of Fraser it did not hold, constituted 'arrangements . . . in contemplation' or 'arrangements proposed' within the meaning of section 75 of the Fair Trading Act 1973 and accordingly fell squarely within the scope of the Commission's inquiry. In the period preceding the reference Lonrho had made it clear publicly and to the Secretary of State and the OFT that it wished to be released from the 1981 undertakings so that the way would be clear to making a full bid. Thus at all material times the general intention to make a full bid was 'in contemplation' and also within the term 'arrangements proposed', that is arrangements in contemplation which have the capacity to lead to a merger situation.

6.3. Lonrho argued that the existence of the 1981 undertakings did not rule out this interpretation. The only way in which the term 'contemplate' could be construed so as to be defeated by preventative undertakings would be if it was coupled with a term such as 'immediate' or 'within its capacity'. No such term appeared in the sub-section and there was no ground for implying one. Thus a person could readily 'contemplate' something even if there was no power to give immediate effect to it, provided that he did not become so divorced from practical reality that 'contemplation' amounted to a day-dream. The 1981 undertakings, however, were not to be regarded as a permanent bar. Indeed, the Government had indicated that it would be prepared to consider at any time representations from Lonrho that, in the light of new circumstances, Lonrho should be released. Further, once the reference had been made the prospect arose that it was at least conceivable that release might be granted in the light of the outcome of the inquiry. In the past a very general indication of intention to bid had sufficed to initiate a valid inquiry. In the present case, there was clearly a genuine intention to make a full bid combined with a determination and ability to do so.

6.4. In connection with its desire to obtain release from its undertakings, in order to make a full bid, Lonrho informed us that it had made approaches in March and July 1983 to the Secretary of State and in June and July 1983 to the OFT, statements to the press in March and May 1984, and it referred to a meeting with the Department of Trade and Industry on 22 May 1984 at which it had submitted that it was willing and able to make a full bid at any time. Lonrho also drew attention to the fact that on 5 July 1984, having received confirmation from its bankers that the necessary finance was available,

the Lonrho Board formally re-affirmed its intention to proceed with the full bid if released from its undertakings. Lonrho also informed us that it had restated its desire to be released from its 1981 undertakings at a meeting at the Department of Trade and Industry on 6 November 1984.

6.5. Lonrho argued that although its intention to make a full bid was not 'specific' at the present stage, the European Ferries<sup>1</sup> case demonstrated that an 'unspecific' intention to bid was sufficient for the purposes of the Act.

6.6. In contesting this view, House of Fraser emphasised that it was essential to distinguish between the powers and functions allotted by the Fair Trading Act to the Commission, the Secretary of State and the Director General of Fair Trading (the Director General). Section 88(4) made it clear that it was the function of the Director General, not of the Commission, to advise the Secretary of State whether an undertaking should be varied, superseded or replaced by an order; and 'varied' was intended to encompass release from an undertaking. While an undertaking remained in force the Secretary of State could not have in mind that the person subject to it would carry arrangements into effect contrary to the terms of the undertaking. If the Secretary of State had in mind the variation or supersession of the undertaking, he was required to seek advice from the Director General, not the Commission. He could not refer a possible bid to the Commission where the bid was barred by an undertaking which he had not decided (in the light of advice from the Director General) to vary, supersede or replace; and for the Commission to find that a barred arrangement was 'proposed' would be to usurp the functions of the Director General to advise concerning the bar and of the Secretary of State to decide whether the bar should continue. Thus, in the European Ferries case, when similar circumstances arose, the Minister sought advice from the Director General, not the Commission, on whether the company should be released from its undertaking.

6.7. This division of responsibilities, House of Fraser submitted, was fundamental to the operation of the Fair Trading Act. A reference to the Commission would be of a particular merger situation appearing to the Minister to exist at a particular time. It was then the duty of the Commission to make a thorough investigation and to advise the Minister about that particular merger situation. If the Commission concluded that that merger situation might be expected to operate against the public interest, and the Minister accepted that conclusion, an undertaking was obtained or an Order made. It then became the duty of the Director General to advise the Minister if he (the Director General) thought there had been a material change of circumstances. The Director General did not, as the Commission did, spend several months examining the position at a particular time. He kept the position under continuous review, and gave advice whenever he thought it necessary. The questions considered by the Commission and the Director General might be very nearly identical, but they considered them in different contexts and in different ways. For example, the Director General might think a party should be released from his undertaking because change of circumstances had made the requirements of the public interest

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<sup>1</sup> Report by the Commission on the proposed merger between European Ferries Limited and Sealink Limited (HC 65 published on 8 December 1981).

uncertain, or in order to see whether the party still had a genuine intention to bid and, if so, whether other bids would follow. If the Minister accepted such advice, and a bid, or bids, were made, those bids could then be referred to the Commission for detailed consideration.

6.8. In the present case House of Fraser argued that it must be assumed that the Secretary of State had not acted *ultra vires* and had not sought the advice of the Commission as to variation or supersession of the 1981 undertakings. What he had referred were the new arrangements in progress or in contemplation. These could not include the possibility of a bid, since the Secretary of State had not decided to supersede or vary the undertakings so as to enable the possibility of a bid to be open to Lonrho. 'In contemplation' could not include what was not practically or lawfully in contemplation, and could not include a matter (ie whether or not the undertakings should be varied or superseded) in relation to which a purported reference would be *ultra vires* and a purported report of the Commission giving advice would equally be *ultra vires*. A reference to the Commission could not involve seeking the advice of the Commission in substitution for the advice of the Director General (which was the only relevant advice) on a matter outside the functions and powers of the Commission.

6.9. Thus a bid could not be 'in contemplation' or 'proposed', when making it would be unlawful. Further, it was no part of the Commission's functions to speculate on whether the Secretary of State might, at some future date, again review the undertakings and conclude in favour of release. The only practical and realistic conclusion at the present time was that the undertakings were in force and would continue in force for the foreseeable future.

### **The Lonrho resolutions**

6.10. For its part, House of Fraser contended until a late stage of the inquiry that a merger situation arose from a different set of circumstances. It asserted that, in the period since the acquisition of SUITS and, more particularly, since the Commission's 1981 report, Lonrho had made sustained and concerted efforts to move from a position of 'material influence' to one of control of the policy of House of Fraser. This course of conduct aimed at achieving 'creeping control' constituted a developing merger situation which culminated in the attempt to 'pack' the Board by the resolutions requisitioned on 16 May 1984 (see paragraph 4.13). In particular, the conclusion which House of Fraser invited the Commission to draw was that the appointment to the House of Fraser Board of the further Lonrho nominees, combined with the size of Lonrho's shareholding and the disposition of the remaining House of Fraser shares, would give Lonrho the ability to control the policy of House of Fraser for the purposes of section 65 of the Fair Trading Act and would thereby result in a merger situation.

6.11. House of Fraser asserted that the control which Lonrho had sought to exercise had both a positive and a negative aspect. Lonrho had sought, by its frequent requisitions of general meetings and resolutions and by its demand for polls at general meetings, its attempts to 'pack' the House of Fraser Board and other actions, to force the Board to adopt policies regarded by all directors of House of Fraser with the exception of the minority directors as contrary to

the interests of House of Fraser. Moreover its obstructive behaviour, its public opposition to policies espoused by the majority of the Board and its frequent public attacks on the management of House of Fraser sought to achieve a negative control of the policy of the company by preventing the Board from implementing plans and policies for the further development and expansion of House of Fraser's business.

6.12. House of Fraser argued that the two most important features of this situation, bearing in mind the tests which the Commission had applied in previous cases, were the proposals for the Board and the dispositions of shareholding. As regards the former, the effect of the proposals would be:

- (a) to increase the maximum size of the Board to 25;
- (b) to install on the enlarged Board a further 12 Lonrho nominees, giving Lonrho a total representation of 14 directors, of whom eight were directors of Lonrho itself, one was a director of a Lonrho subsidiary, and the remainder appeared to have financial or other connections with Lonrho;
- (c) by reason of (b), to give Lonrho an overall majority on the House of Fraser Board; and there was also the subsequent proposal to remove from House of Fraser's Board two independent directors, namely Professor Smith, both as Chairman and as director, and Mr Sharp.

House of Fraser argued that the directors of Lonrho would plainly not act contrary to Mr Rowland's wishes. As regards the other nominees the apparent connections between them and Lonrho were sufficient to cast considerable doubt on their independence. It was difficult to conceive that any of the nominees would exercise an independent judgment against the wishes of Mr Rowland who would have been responsible for putting them on the House of Fraser Board. As was apparent from the Commission's report on the GUS reference,<sup>1</sup> the fact that a nominee to a Board was in law required to act in the general interest of the shareholders as a whole was in no sense inconsistent with the ability of the party making the nomination to control the policy of the company within the meaning of section 65 of the Fair Trading Act. On the contrary, nominees to the Board of a company could never safely be treated as independent if promoted by a single shareholder in circumstances where such shareholder's motives may not be adjudged, as House of Fraser argued, as being consistent with the best interests of all shareholders.

6.13. Furthermore, House of Fraser argued that, consistently with the Commission's reasoning in previous references, 'policy' as used in section 65 of the Act did not necessarily involve the exercise of, or even the ability to exercise, control over all aspects of policy. Control over the policy of a body corporate seldom involved absolute control over all aspects of that policy: it was sufficient to constitute control of the policy for the purposes of section 65 that a party had the ability to impose its will on major aspects of the management of the company's business. In any event, in the special circumstances of the present case, control of the policy of House of Fraser on the demerger of Harrods would inevitably and necessarily result in the control of the policy of

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<sup>1</sup> Report on the proposed merger between Great Universal Stores PLC and Empire Stores (Bradford) PLC (Cmnd 8777 published January 1983).

the company within the meaning of the section. Demerger would go to the heart of House of Fraser's future. It would change House of Fraser fundamentally and it was difficult to see how control of a company's 'policy' could be more complete than that. Control of House of Fraser's policy in relation to demerger would inevitably lead (and was intended by Lonrho to lead) to overall control of all aspects of House of Fraser's policy and ultimately to control of House of Fraser itself.

6.14. House of Fraser also argued that it was also relevant to have regard to the fact that there had been a critical shift in the shareholding balance in the company between 6 May and 30 June 1983. The result was that Lonrho gained the support of substantial new shareholders whose shares, together with those of Sir Hugh Fraser and the Fraser trusts and family, represented approximately 8.1 per cent of the ordinary share capital of House of Fraser. House of Fraser contended that, whether or not the holders of these shares were properly to be regarded as persons 'associated' with Lonrho within the meaning of section 77 of the Act (see paragraphs 7.26 and 7.34), the reality was that the shares had been and would continue to be voted in tandem with Lonrho and that Lonrho accordingly had effective control of some 38 per cent of the issued share capital of House of Fraser.

6.15. Lonrho denied that there was any question of a merger situation on the grounds advanced by House of Fraser. The Griffiths report had found that Lonrho did not control more than 29.9 per cent of the shares. As regards the composition of the Board of House of Fraser, for Lonrho to exercise control of Board policy, it would have to be able to control the votes of all but one of a group of 14 made up of eight of its own directors and six independents on all matters with which the Lonrho group was in conflict with the House of Fraser group. It would admittedly be unreasonable to suppose that the Lonrho directors would not generally have the same commercial view as Lonrho on matters coming before the Board but this would not necessarily be the case in respect of every director on every issue. The independent directors were individuals of substance whose remuneration, employment and in-house advice would come from House of Fraser, not Lonrho. A finding that either the Lonrho or the independent directors of House of Fraser would be under Lonrho's control involved a finding that they would be prepared to act contrary to the requirements of their fiduciary duty to House of Fraser as directors and such a finding should not be made unless the evidence was compelling. This was not the case. The independent directors had been selected because they were known in one way or another to Lonrho Board members but the only other way to proceed would have been to pick individuals out of the air.

6.16. Further, although Lonrho would retain the ability materially to influence the policy of House of Fraser it would not by the means suggested obtain the ability to control it. 'Control' was an absolute term and the ability to control was a positive state. It was necessary not merely to have the possibility or the potentiality of control but actually to be able to control the whole of the policy on every issue; and there must be some tie or connection between Lonrho and the directors in question, linking the director's views with those of Lonrho although he or she would not otherwise hold them. This was not the case.

6.17. Lonrho denied that it had any wish or instituted any campaign to achieve control by any means other than a full bid. All its actions had been motivated by the desire to protect and improve its substantial investment. The Commission had accepted (in paragraph 4.52 of their 1981 report) that, after 1980, an adversary situation existed in which Lonrho was justified in taking action to protect its investment. At all times the actions of the minority Lonrho directors on the House of Fraser Board had been directed to performing their statutory duties as directors of House of Fraser, irrespective of the difficulties put in their way by the majority of the House of Fraser Board.

#### **Further developments**

6.18. As we indicated in paragraph 6.1, the issues described in paragraphs 6.2 to 6.17 existed throughout most of the inquiry. However, towards the end of the inquiry Lonrho, after the sale of its 29.9 per cent holding in House of Fraser, stated that it had abandoned the particular proposals contained in the resolutions requisitioned on 16 May 1984 (see paragraph 6.10) and had no present intention of reviving such proposals. House of Fraser then submitted that, in the light of all the circumstances, including the resignation of Lord Duncan-Sandys and Mr Rowland from the House of Fraser Board as from 31 December 1984, Lonrho had irrevocably abandoned its proposal to increase its representation on the Board of House of Fraser. It accordingly argued that the Commission was required, subject to the consent of the Secretary of State, to lay the reference aside pursuant to section 75(5) of the Fair Trading Act since 'the proposal to make arrangements such as are mentioned in the reference' had been abandoned.

6.19. House of Fraser submitted that the only relevant 'arrangements' were those which led up to the making of the reference by the Secretary of State and were referred to in the reference either expressly or by necessary implication, namely Lonrho's requisitions of 16 May 1984. It was not possible for the Secretary of State to make a reference of something in respect of which he was the recipient of an undertaking which rendered it unlawful. Thus any intention to make a bid was not in the mind of the Secretary of State when he made the reference. House of Fraser argued that Lonrho's attempt to secure a release from the undertakings had been abandoned in September 1982 (see paragraph 4.6) and there had been no formal application requesting release thereafter. The Lonrho Board's resolution of 5 July 1984 (see paragraph 6.4), which it had not communicated to House of Fraser, was a tactical manoeuvre made after the reference had been made. The provisions of section 75(5) were not directed to arrangements which might be proposed or take place at some later date after the reference was under way. If there was a fresh matter in contemplation, such as a bid, the normal consequence would be that the Secretary of State would make a fresh reference in relation to it and the two references would proceed in tandem.

6.20. In any event, quite apart from the considerations referred to in paragraphs 6.18 and 6.19 relating to the reference, Lonrho's purported intention to renew its bid should be regarded as abandoned for the purposes of section 75(5) of the Act. In view of the subsisting undertakings given by Lonrho and in the light of the fundamental changes in circumstances, including the sale by Lonrho of its 29.9 per cent shareholding in House of Fraser and the resignation

of its two directors from the Board of the company, there was no realistic basis (in law or in fact) for treating any such proposal on the part of Lonrho as an effective and subsisting proposal.

6.21. Lonrho explained that it had sold its 29.9 per cent holding on 2 November 1984 (see paragraph 4.16) because it received a straightforward cash offer for the whole of its shares in House of Fraser at an attractive price at a time when it was concerned at the decision announced on 30 October 1984 to extend the duration of our inquiry by three months. The possibility that the outcome of our inquiry might be adverse to Lonrho and thus result in a substantial fall in the value of a major investment could not be ruled out. Lonrho thought it right to reduce its risk exposure and, at the same time, benefit from a considerable profit on the transaction.

6.22. As regards the subsequent transactions which had given Lonrho a 6.3 per cent holding by the end of November 1984, House of Fraser argued that it was significant that shares purchased by Lonrho were sold by shareholders referred to in paragraph 6.14. Lonrho strongly asserted that the share purchases had not been made by reason of any prior arrangement with the sellers since Lonrho had purchased in the market and did not know in advance where the shares originated. They had been purchased after confirmation by the Minister that it was in order to purchase shares back up to 29.9 per cent. The reason for the purchase was that Lonrho was still interested in House of Fraser, in which it had been involved for several years, and wished to demonstrate its continuing intention to make a full bid.

6.23. Lonrho also explained that the fact that it now had a much smaller holding of shares in House of Fraser was certainly one of the factors, amongst many others, affecting a decision as to precisely when, on what terms and in what form it would make a bid. Such questions of means and timing, however, did not affect Lonrho's fundamental attitude, namely that it remained extremely interested in House of Fraser. It had made a massive investment of time, effort and money over a number of years in getting to know the business. It would be an extraordinary situation if the Commission were to find that there was no merger situation because Lonrho's stated intention to make a bid, if allowed to do so, was not believed. Once the Commission had decided that a merger situation existed, they were required to report and could only refrain from doing so if there was an abandonment of intention. This required not merely the objective test that it might be undesirable or difficult for Lonrho to maintain a bid but also a finding about the subjective intention of Lonrho that it had in its own mind abandoned the idea and that all references to the contrary were merely a false stance adopted for some other reason.