Companies and Securities Advisory Committee

Compulsory Acquisitions and Buy-outs

March 1999

This Advisory Committee Paper responds to the matters raised in the January 1999 submission by the Australian Shareholders' Association (ASA) to the Parliamentary Joint Committee on Corporations and Securities on Chapter 6A of the Corporate Law Economic Reform Program Bill (the CLERP Bill).

The CLERP Bill proposes to reform the existing provisions for compulsory acquisitions and buy-outs following a successful takeover bid and to introduce new compulsory acquisition and buy-out provisions that would operate without the need for a prior takeover bid. These reforms are based on the *Compulsory Acquisitions Report* (January 1996) prepared by the Legal Committee of the Advisory Committee.

The ASA submission raises three general objections to the CLERP Bill proposals. It:

- questions the need for the proposed new compulsory acquisition power (as found in Part 6A.2 of the CLERP Bill)
- argues that the criteria for assessing the exercise of any compulsory acquisition power should be whether the offer is "fair and reasonable", rather than being limited to whether the price offered represents fair value, and
- expresses concern about ensuring the independence of experts in preparing their reports to minority shareholders.

The ASA submission also raises various drafting issues concerning the CLERP Bill provisions.

Part 1 of this Paper deals with the three general matters raised in the ASA submission. Part 2 of the Paper deals with the additional drafting issues raised in the ASA submission.

Part 1. General matters

For the reasons set out below, the Advisory Committee strongly supports the current draft CLERP Bill provisions. It does not agree with the three general objections raised in the ASA submission.

Benefits of additional compulsory acquisition power

The Advisory Committee supports the recommendation in the *Compulsory Acquisitions Report*, that a new compulsory acquisition power be enacted alongside the existing power. The new power may provide considerable economic, administrative and taxation benefits for those Australian companies that are 90% or more owned by a single shareholder. Those benefits include:

- facilitating financial restructuring
- permitting the transfer of tax losses between wholly owned grouped companies

- reducing administrative and reporting costs
- avoiding greenmailing
- protecting the confidentiality of commercial information and otherwise eliminating possible conflicts of interest in partially owned companies.

The proposed procedure in the CLERP Bill also ensures that minority shareholders receive fair consideration for their shares.

Fair value

The Advisory Committee supports the proposed procedures for exercising either compulsory acquisition power, including that the only issue for an independent expert, or a court where the procedures are correctly followed, should be whether the consideration offered constitutes fair value. There should be no "proper purpose" requirement for the exercise of a compulsory acquisition power, nor should the court have any power to set aside a compulsory acquisition on any non-procedural grounds other than fair value. Either provision could give rise to protracted litigation and legal uncertainties, given the High Court's support in *Gambotto v WCP Ltd* (1995) 128 CLR 432 for the proprietary rights of individual shareholders. The Legal Committee and various respondents to the Compulsory Acquisitions Review, including the Law Council of Australia, were concerned to ensure that the *Gambotto* principles do not apply to compulsory acquisitions. The Advisory Committee supports this position.

Section 667C of the Bill sets out the criteria for determining fair value. The Advisory Committee supports those criteria, which reflect the recommendation in the *Compulsory Acquisitions Report*.

In addition to these general observations on fair value, the Advisory Committee makes the following comments specifically directed at the two types of compulsory acquisition.

Application to compulsory acquisitions following a successful takeover bid

The ASA submission argues that the criteria for assessing a compulsory acquisition offer should be whether it is fair and reasonable. The value of the consideration should only be one factor in this determination. Other factors might include any element of cheating, deception or impropriety or materially misleading statements in the offer documents. The ASA argues that to deny consideration of broader "fair and reasonable" factors would seriously reduce the protection provided by the law to minority shareholders.

The Advisory Committee considers that the various specific factors other than fair value referred to in the ASA submission are more relevant to the propriety of the takeover bid itself and should be considered in that context, not that of the consequential compulsory acquisition.

To broaden the criteria for challenging a compulsory acquisition beyond fair value may also discourage some persons from conducting takeover bids, to the detriment of shareholders generally. General fair and reasonable criteria would create uncertainty

about whether bidders could compulsorily acquire remaining shares even where they have satisfied the proposed compulsory acquisition threshold test. By contrast, the proposed fair value criterion provides certainty for bidders. Also, the threshold test ensures that a bidder cannot proceed to compulsory acquisition unless fully-informed offeree shareholders not associated with the bidder have overwhelmingly accepted the bid.[1]

Application to the proposed new compulsory acquisition power

The Advisory Committee considers that the proposed new compulsory acquisition procedure adequately protects the interests of minority shareholders. Under the provisions, the 90% holder would be required to provide remaining shareholders with at least one independent expert's opinion on whether the consideration offered represents fair value. That holder would also be required to obtain court approval of that valuation if more than 10% of the remaining shareholders dissented. In practice, this would place an onus on the 90% holder to prove fair value. In addition, objectors could bring evidence in any court proceedings to challenge whether the value is fair. The effect will be that 90% holders would tend to offer a premium value to reduce the chances of having to go to court, or the value offered being open to serious disputation in any court proceedings.

The Committee also notes that minority shareholders may benefit from being offered fair value for their shares. Those shareholders could be disadvantaged if a small group of dissident shareholders could stop the compulsory acquisition process by arguing grounds other than fair value.

The independence of the expert

The Committee notes that the CLERP Bill would require the disclosure of any prior dealings or relationships between the expert and the 90% holder. In addition, a court could assess any concerns about whether an expert's report properly assessed fair value in determining whether to approve the compulsory acquisition. The Committee considers that these controls are adequate and satisfactory in this context.

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[1] The effect of the threshold test in s 661A(1)(b) of the CLERP Bill (which reflects the *Compulsory Acquisitions Report* recommendation) is that a bidder must acquire at least 90% of the total securities of the bid class and have also received acceptances from non-associated offeree shareholders holding at least 75% of the outstanding shares. In consequence, where the bidder's entitlement at the outset of the bid exceeds 60%, that threshold increases beyond 90% (for instance, 92.5% where the bidder's initial entitlement is 70%, 95% where the bidder's initial entitlement is 80%).

Part 2. Specific drafting issues

Compulsory acquisitions and buy-outs following a successful takeover bid

1. Compulsory acquisitions of bid class securities (ss 661A-661F)

Under these provisions, a bidder who, pursuant to a takeover bid, has satisfied the requisite threshold may elect to compulsorily acquire all the remaining bid class securities. The provisions set out the procedure for compulsory acquisition and the rights of dissidents to object.

Notice to shareholders

Under s 661B, the bidder must send a notice in the prescribed form to the holders of the securities to be compulsorily acquired. The ASA submission points out that there is no specific requirement that the notice inform the holders of their rights under ss 661D (obtaining names and addresses of other holders) and 661E (right to apply to court to stop an acquisition).

Advisory Committee response. Shareholders should be fully informed of their rights. The types of matters referred to in the ASA submission are included in the notice to shareholders under the proposed new compulsory acquisition power (s 664C(1)(c)). Section 661B could be amended to make specific reference to the matters in ss 661D and 661E, or alternatively these matters could be included in the prescribed form.

Power of the court

Subsection 661A(3) is a new provision that permits a bidder who has not satisfied the prerequisites for compulsory acquisition to nevertheless apply to the court for approval to compulsorily acquire securities in the bid class.

The ASA submission correctly points out that this provision is based on a specific recommendation in the *Compulsory Acquisitions Report*. The ASA supports inclusion of this power, but believes its scope and the criteria for its exercise should be stated more precisely in the legislation. It suggests that the legislation should state that the court should have the power to approve a compulsory acquisition if satisfied that:

- after reasonable inquiry the bidder has been unable to trace the shareholders to whom the offer relates
- the shares which the bidder has acquired (or contracted to acquire), together with those of the untraced shareholders, amount to not less than the 90% threshold, and
- the consideration is fair and reasonable.

Advisory Committee response. The Committee notes that the Compulsory Acquisitions Report specifically recommended that the court's powers not be confined to instances where the number of untraceable shareholders prevents the

bidder from reaching the compulsory acquisition threshold. Respondents to the earlier Issues Paper also opposed any power being specifically confined in this manner. There may be particular bids not involving untraceable shareholders where it is appropriate for compulsory acquisition to proceed even though the requisite threshold test has not been satisfied.

The Advisory Committee notes that the Explanatory Memorandum to cl 661A of the CLERP Bill provides guidance for the court's discretionary exercise of its power, for instance, where a bidder falls just short of the threshold or the target company issues new shares during a bid. The Advisory Committee supports this approach. A further possibility may be for the legislation to state that the court could exercise its power under s 661A(3) where in all the circumstances it considers it appropriate to relieve a bidder from strict compliance with the formal prerequisites for compulsory acquisition.

2. Right of holders of bid class securities to be bought out (ss 662A-662C)

Under these provisions, a successful bidder who has acquired at least 90% of the bid class securities, but does not exercise the compulsory acquisition powers, may nevertheless be required to purchase the bid class securities of any remaining minority shareholders who wish to be bought out.

Terms of acquisition

Paragraph 662C(2)(c) provides that the holder and the bidder may agree to terms of the buy-out. The ASA argues that if it is the intention of para (c) that each holder of securities will be able to negotiate separately with a bidder regarding the terms on which he or she is to be bought out, then this appears to be contrary to the Eggleston principle that all holders of securities of the same class should be treated equally.

Advisory Committee response. Paragraph 662C(2)(c) of the CLERP Bill simply reflects s 703(3) of the Corporations Law which provides that "the offeror is entitled and bound to acquire those shares [on specified terms] or on such other terms as are agreed or [as the Court thinks fit to order]". This is a long-standing provision and was not raised in any submission to either the takeover anomalies review or the compulsory acquisitions review. This matter was not dealt with in the Compulsory Acquisitions Report.

The Committee notes that the provision has rarely been used in practice, given that holders of bid class securities who wish to be bought out will usually accept the bid. However, the provision provides flexibility for a shareholder who wishes to be bought out following the bid, for instance where the shareholder seeks a different type of consideration than that offered under the bid. The Committee therefore supports the provision in its current form.

3. Right of holders of convertible securities to be bought out (ss 663A-663C)

Under these provisions, the holders of securities convertible into bid class securities may require that their securities be purchased by a bidder who has acquired at least 90% of the bid class securities.

Terms of the buy-out offer

The ASA submission raises a number of technical issues with s 663C, namely:

- does the notice given by a holder of convertible securities to the bidder pursuant to s 663C(1) constitute an acceptance by the holder on the terms set out in the notice to the holder pursuant to s 663B(1)?
- can a contract arise between parties when the price and other terms and conditions of the contract are not specified?
- is it the intention of s 663C(2)(a) that each holder of securities will be able to negotiate separately with a bidder the terms on which he or she is to be bought out?

Advisory Committee response. The terms of s 663C suggest that the notice given by the bidder under s 663B(1) represents a contractual offer by the bidder to buy out the convertible securities, open to acceptance by the holder either under the terms agreed to by the bidder and the holder or as otherwise determined by the Court (s 663C(2)). Without that agreement or court determination, the terms of the contract are not settled. The ASA's concern that the bidder's notice under s 663B(1) may itself lock the holder into the terms specified in that notice appears to be unfounded.

Section 663C does contemplate that holders of convertible securities could individually negotiate with the bidder. This raises the same issues as those discussed under *Terms of acquisition* (p 5, supra).

Powers of the court

The ASA submission questions whether it is the intention of s 663C(2) that each holder of convertible securities will be able to make a separate application to the court to determine the terms and conditions on which his or her securities are to be bought out.

Advisory Committee response. Any court order under various other provisions in Chapter 6A of the CLERP Bill applies to all securities of the same class, thereby ensuring that there is only one court determination.[2] The Committee considers that the same approach should apply under s 663C (and also s 665C).

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[2] Under s 661E(3), any court order under s 661E applies to all holders who have applications pending under the section. Likewise, any court decision to approve or disapprove an acquisition under s 664F applies to all securities proposed to be acquired.

Compulsory acquisitions and buy-outs not related to a prior takeover bid

1. Compulsory acquisition of securities by a 90% holder (ss 664A-664G)

Notice to holders

Under s 664C(1)(c)(i), minority holders are to be informed about their right to obtain the names and addresses of the other minority holders of securities in that class from the company register. The ASA points out that these minority holders are not given the right to obtain that information from the 90% holder itself within 7 days, as is the case following a successful takeover bid (s 661D). The ASA argues that this difference may put minority holders at a disadvantage under the new compulsory acquisition procedure, compared with dissenting holders under a takeover bid.

Advisory Committee response. The Advisory Committee supports the company, rather than the 90% holder, having the onus to provide the information to minority shareholders. The company would be in a better position to provide up to date information. Also, any cost to the company would, in effect, be indirectly borne by a person who becomes a 100% holder.

Parties to litigation

The ASA argues that although s 664F(2) places the onus on the 90% holder to apply to the court for approval of the compulsory acquisitions (where at least 10% of the minority holders object), it is unlikely that the interests of the minority holders will be adequately represented unless they are parties to the litigation.

Advisory Committee response. The Advisory Committee notes that the Compulsory Acquisitions Report was concerned to overcome any financial disincentives to dissenting shareholders becoming parties to the litigation. This is reflected in s 664F(4) which provides that:

> "The 90% holder must bear the costs that [any dissident shareholder] incurs on legal proceedings in relation to the application unless the Court is satisfied that the [dissident shareholder] acted improperly, vexatiously or otherwise unreasonably. The 90% holder must bear their own costs."

The draft provisions are therefore designed to overcome financial barriers to minority shareholders being parties to litigation.

2. Right of holders of convertible securities to be bought out by a 100% holder (ss 665A-665C)

This Division provides that a person who has a full beneficial interest in 100% of a class of securities through compulsory acquisitions under the proposed new compulsory acquisition procedure must offer to buy out the holders of securities in any other class that are convertible into that class.

Possibility of avoidance

In informal discussions, the ASA questioned whether the obligation to buy out convertible securities could be circumvented by the 100% holder simply selling one share.

Advisory Committee response. Subsection 665A(2) provides that a person:

> "who becomes a 100% holder [of a main class of securities] through compulsory acquisitions under this Part must offer to buy out the holders of securities in another class that are convertible into main class securities …".

A person who employs the compulsory acquisition powers under this Part must acquire all outstanding securities of the bid class, thereby becoming the 100% holder. The obligation to buy out convertible securities arises at that point, and cannot be circumvented by subsequently selling one or more shares of the bid class.

The buy-out threshold

The ASA submitted that the criterion for buy-out should be a holding of 90% or 95% rather than 100%. It pointed out that a 90% threshold test applies in relation to securities convertible into bid class securities (see **Right of holders of convertible securities to be bought out**, p 5, supra).

Advisory Committee response. The right of holders of convertible securities to be bought out under ss 665A-665C was intended to apply only where a shareholder successfully employed the new compulsory acquisition powers.3 It would be contrary to this philosophy to lower the threshold in the manner suggested in the ASA submission. It would impose a buy-out obligation on a 90% or 95% shareholder who did not seek to compulsorily acquire the remaining shares.

Notice to holders

Section 665B sets out the requirements for notice to holders of convertible securities. They must be advised of their buy-out rights and the cash sum for which the 100% beneficial holder is willing to acquire the convertible securities, and be given one or more expert's reports on whether that sum represents a fair value for the securities concerned. However, the ASA points out that the notice need not include additional information given to recipients of compulsory acquisition notices under the general compulsory acquisition power, as set out in s 664C(1)(c)-(e).

Advisory Committee response. The Advisory Committee considers that the equivalent of the general disclosure requirements in s 664C(1)(e) should apply to notices given to holders of convertible securities. These holders may not have received any information where the compulsory acquisition applied to another class of securities into which their securities are convertible.

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3 *Compulsory Acquisitions Report* para 10.40.

Terms of the buy-out offer

The ASA argues that s 665C(2) gives rise to the same types of legal and practical problems as s 663C(2).

Advisory Committee response. These matters are already discussed under *Terms of the buy-out offer* (p 6, supra).