Companies and Securities Advisory Committee

Recommendations for reform of ss 621(4) and 623(2) & (3) of the Corporate Law Economic Reform Program Bill 1998

December 1998

In this Paper, the Advisory Committee recommends that:

- s 621(4) of the Corporate Law Economic Reform Program Bill December 1998 (the CLERP Bill) be extended to all bids, including non-cash-only-bids. The Bill should stipulate that the value of any quoted shares offered as part of the consideration should be determined as the average of the market price paid for those shares in the five trading days prior to the announcement of the bid.
- the Government not proceed with s 623(2) & (3) of the CLERP Bill.

CLERP Bill s 621(4): The *Evans Deakin* takeover bid

The terms of the bid

On 14 October 1998, Evans Deakin purchased 78 million ANI shares on the stock exchange at $1.05 each. Subsequently, on 19 October 1998, Evans Deakin made a conditional Part A cash and scrip bid (with no cash-only option) for ANI. That bid valued the ANI shares at approximately 90c each.

As explained below, Evans Deakin was not required to offer bid consideration at least equivalent to the on-market cash price it paid for ANI shares immediately prior to the bid, given that it made a non-cash bid. That obligation to match pre-bid prices only applies to cash or cash-only alternative bids.

Current law

Under the current equivalent of the CLERP Bill s 621(4). where a bidder makes a bid that is cash-only or includes a cash-only alternative:

> the cash or cash alternative bid price must be no less than the highest price paid (or agreed to be paid) by the bidder (or its associates) for target company shares in the four months prior to the bid (the minimum bid consideration requirement).[1]

By contrast, where a bidder makes a non-cash-only bid (that is, any bid that does not provide a cash-only alternative):

> the value of the bid consideration need not match any price the bidder paid for target company shares in the four months prior to the takeover bid.[2]

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[1] Section 641 of the Corporations Law, as reflected in s 621(4) of the CLERP Bill. The cash or cash alternative bid price may be reduced with the approval of ASIC in any of the circumstances set out in s 641(1)(d).

[2] Section 641 (s 621(4) of the CLERP Bill) does not apply to non-cash-only bids.

Advice by the Legal Committee

The Advisory Committee at its 19 October 1998 sought the advice of the Legal Committee on the various legal implications of the *Evans Deakin* takeover bid.

The Legal Committee considered the *Evans Deakin* takeover bid at its 13 November meeting, and forwarded its advice to the Advisory Committee for its 30 November meeting.

The Legal Committee saw the issue as whether s 621(4) of the CLERP Bill should be extended to cover non-cash-only-bids or, conversely, should not be proceeded with (in effect repealing s 641 of the Corporations Law).

Some Legal Committee members favoured extending s 621(4) of the CLERP Bill to cover all bids. Other Legal Committee members considered that the Government should not proceed with s 621(4) of the CLERP Bill.

Arguments for extending CLERP Bill s 621(4) to all bids

Some Legal Committee members put forward the following arguments for extending this provision to all bids.

- It is anomalous that there is a mandatory minimum bid consideration for cash-only or cash alternative bids but not non-cash-only-bids.

- Offeree shareholders are often interested in changing their shareholdings from one company to another, and are often offered scrip as consideration in a takeover for that reason. Currently, these shareholders do not have the protection of s 641 of the Corporations Law (CLERP Bill s 621(4)).

- The non-application of CLERP Bill s 621(4) to non-cash-only-bids may create an incentive for prospective bidders to offer institutions cash at a premium in the pre-bid period, particularly where the institutions are made aware that the purchaser will conduct a subsequent non-cash-only-bid for a lesser consideration. Equally, it may place undue pressure on these shareholders to sell out for cash in the pre-bid period.

Another possible argument for extending CLERP Bill s 621(4) to all bids is that a bidder who plans to conduct a non-cash-only-bid may discourage potential competing bidders by moving quickly to a strategic 20% initial stake at an inflated cash price that a prospective competing bidder who planned to make a cash or cash alternative bid was unwilling to offer (given that only the prospective competing bidder would be tied to that inflated price for the whole of its bid). Without a competing bidder, offeree shareholders may have little real choice but to accept the non-cash bid consideration, even if it is considerably less than the cash paid by the bidder in the pre-bid period.

The members noted that any proposal to extend CLERP Bill s 621(4) could require the fine adjustment of non-cash-only-bids to ensure that the consideration offered was no less than the highest pre-bid consideration paid by the bidder or any associate. This problem could be overcome by making minor adjustments to non-cash-only-bids, for

instance by having calibrated share swaps (10 for 11, 99 for 150) or by paying an additional small cash price per share as well as the non-cash consideration. Also, the bid consideration can exceed the highest pre-bid consideration, if necessary.

Arguments for not proceeding with CLERP Bill s 621(4)

Some Legal Committee members put forward the following arguments for not proceeding with this provision.

- The proper focus of takeover regulation should be equality of opportunity for shareholders after, but not before, a bid has commenced.

- The *Evans Deakin* situation was unusual. In order to succeed in a bid, market forces would ensure in most cases that the bidder would be required to offer a consideration at least as attractive as the pre-bid market price.

- CLERP Bill s 621(4) (like CLERP Bill s 623(2) and (3) - see discussion of the *Aberfoyle* decision, post) was inconsistent with a bidder being free to acquire up to 20% unfettered by takeover regulation. The philosophy to permit unrestricted acquisitions up to 20% ensures that bidders can obtain a platform from which to launch a bid. Any fettering of the ability to acquire such a platform could stifle takeover activity in Australia.

- Not proceeding with CLERP Bill s 621(4) would complement the proposed new CLERP mandatory bid rules under which bidders (having acquired more than 20%) will have to offer cash or, in a scrip bid, a cash alternative of equivalent value.

- The takeover provisions should not discourage scrip bids. Some bidders are already reluctant to offer scrip because of the increased risk of litigation. Many small shareholders greatly value the opportunity of being offered scrip. An extension of CLERP Bill s 621(4) to apply to scrip may further discourage scrip bids.

- The possibility that CLERP Bill s 621(4) could create an incentive for prospective bidders to offer institutions cash at a premium in the pre-bid period may not often arise in practice.

- Some forms of collateral intangible benefits provided in the four month pre-bid period cannot be converted into bid consideration.

Advisory Committee recommendation

The Advisory Committee considered this matter at its 30 November meeting, taking into account the Legal Committee's advice.

The Advisory Committee members discussed the possibility of not proceeding with CLERP Bill s 621(4), subject to the bidder disclosing in the takeover documents the details of consideration paid for the purchase of any target company shares, and any other benefits that were given to the vendors of target company shares and that had any connection with the sale of those shares, in the four month pre-bid period.

The predominant view amongst Advisory Committee members was that, rather than rely on disclosure in lieu of CLERP Bill s 621(4), that provision should be retained and extended to cover all bids. They considered that, in the absence of s 621(4), some shareholders could obtain considerable premiums for selling their target company shares in the pre-bid period, compared with the price offered to offeree shareholders. This might create a perception of inequitable treatment among shareholders. Institutions might also be placed under pressure to enter into pre-bid share deals on terms that would not be available to offeree shareholders under the bid.

The Advisory Committee members also considered that, if CLERP Bill s 621(4) is extended to all bids, the value of any quoted shares offered as part of the consideration should be determined as the average of the market price paid for those shares in the five trading days prior to the announcement of the bid. This would overcome any unusual late price movements.

Recommendation

The Advisory Committee recommends that CLERP Bill s 621(4) be extended to all bids, including non-cash-only-bids. The Bill should stipulate that the value of any quoted shares offered as part of the consideration should be determined as the average of the market price paid for those shares in the five trading days prior to the announcement of the bid.

CLERP Bill s 623(2) & (3): The *Aberfoyle* takeover bid

The decision

Overview

Subsections 698(2) & (4) of the Corporations Law, and s 623(2) of the CLERP Bill, prohibit an intending bidder in the four months preceding its bid from giving some shareholders of the intended target company any benefit that the intending bidder is not proposing to provide under the takeover offer. The CLERP Bill s 623(3) contains an equivalent prohibition in relation to mandatory bids. However, this prohibition on pre-bid benefits does not apply to any target company shares acquired on-market in that period by the intending bidder (s 698(5)(b), CLERP Bill s 623(5)(b)).

The recent judgment of Finkelstein J in *Aberfoyle Ltd v Western Metals Ltd* (1998) 28 ACSR 187 has raised market concerns about the application of s 698(2) & (4) to various transactions in the four month pre-bid period, being:

- unconditional acquisitions by the bidder of target company shares from institutional investors prior to a conditional bid
- crossings (where a broker knows and acts for both the buyer and seller of target company shares in a transaction) under SEATS, the buyer being the intending bidder
- the placement of bidder company shares with institutional investors in the target company.

Unconditional acquisitions of target company shares in the four months before a conditional bid is launched

In *Aberfoyle*, various institutional investors sold their target company shares to the intending bidder in the four month pre-bid period under unconditional cash contracts. By contrast, the subsequent takeover bid was a conditional cash offer.

Finkelstein J said that these pre-bid institutional vendors of target company shares may have gained a "very real commercial advantage (perhaps measurable in money) … when compared with a person who enters into a conditional contract [under the subsequent takeover bid] and whose ability to sell his [target company] shares is contingent on a range of events none of which he has any ability to control".

Before the *Aberfoyle* decision, most practitioners and ASIC[3] considered that this form of pre-bid cash transaction for target company shares would not constitute a benefit prohibited by s 698 (given that the bid price could be no less than the highest cash payment in that period[4]).

The High Court in *Sagasco Amadeus Pty Ltd v Magellan Petroleum Australia Ltd*[5] held that mere earlier payment under a pre-bid arrangement did not constitute a benefit prohibited by s 698. However, this judgment did not make clear:

- whether this principle applied only to later *unconditional* cash bids or also to later *conditional* cash bids,[6] and

- for *conditional* cash bids, whether any distinction should be drawn between bids subject only to prescribed occurrence conditions and those subject to other conditions. Subsequently, Santow J in *Boral Energy Resources Ltd v TU Australia (Queensland) Pty Ltd*[7] questioned whether a prohibited benefit would arise for pre-bid acquisitions if the only bid conditions were prescribed occurrence conditions, given that, in his view, these conditions "are treated as quite unlikely to occur and thus their absence is not likely to be significant in the non-bid transaction".[8]

Crossings of target company shares

In *Aberfoyle*, the pre-bid sale by some institutions of their target company shares to the bidder was conducted by a broker acting for both sides under a crossing arrangement. The question arose whether this arrangement fell within the ordinary course of trading exception which states that:

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[3] ASIC Information Release 95/31.

[4] s 641.

[5] (1993) 10 ACSR 398 at 403.

[6] The acquisition of shares under unconditional contracts preceding a conditional takeover bid was held to be a benefit in *Boral Energy Resources Ltd v TU Australia (Queensland) Pty Ltd* (1998) 28 ACSR 1, *Attorney-General (Vic) v Walsh's Holding Ltd* [1973] VR 137 and *Albert v Votraint No 320 Pty Ltd* (1987) 13 ACLR 336.

[7] (1998) 28 ACSR 1.

[8] (1998) 28 ACSR 1 at 34.

> "Nothing in this section prohibits the acquisition of shares in a company at an official meeting of a stock exchange in the ordinary course of trading on the stock market of that stock exchange".[9]

Finkelstein J held that a crossing transaction was not in the ordinary course of trading on the ASX and therefore did not fall within the exemption. He ruled that only those transactions that operated on a 'first come first served' anonymous basis would satisfy the ordinary course of trading test, whether they took place on the trading floor, as in the past, or now on SEATS. On this basis, no crossing could satisfy the ordinary course of trading test.

The distinction drawn in this case between anonymous trading and a crossing has been criticised as artificial, "because if one buyer is in the market purchasing large lines of stock in a company, it is clearly not normal and the identity of the buyer is often well-known".[10]

Other views in favour of exempting crossing transactions include:

- crossings are arguably the ordinary course of trading for the wholesale market. That market, unlike the retail market, is not anonymous, but involves larger trades usually done by buyers sounding out institutional investors and buying brokers booking the sales as crossings

- when supply exceeds demand, a broker, through crossings, can allocate purchases pro rata to afford sellers equality of treatment. Requiring buyers to bid blind on an anonymous market advantages those sellers best placed to respond quickly and denies other sellers equality of opportunity

- as a result of the *Aberfoyle* decision, some buying brokers have been told not to book crossings when acquiring a strategic stake on-market. These buying brokers have refused to accept any sell orders for the same shares, referring the sellers to other brokers. Their actions might alert these sellers to the possibility that the broker is acting for a party who is seeking to accumulate a strategic stake in advance of a takeover bid. This might also alert arbitrageurs that a strategic stake is being accumulated for a bid and encourage them to overbid, assured of a bid "floor" price.

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9 s 698(5)(b), CLERP Bill s 623(5)(b).

10 Chanticleer, *Australian Financial Review* Friday 9 October 1998.

Placements of bidder shares with the target's institutional investors

In *Aberfoyle*, the bidder, in the four month pre-bid period, issued some of its ordinary and converting preference shares to certain institutional investors to raise money for its proposed bid. Some of those institutional investors were also, at that time, shareholders of the prospective target. The discussions with these institutions covered the bidder's intended acquisition of a pre-bid stake in the target as well as the placement of the bidder's own shares with the institutions. The consideration under the subsequent takeover offer did not include any of the bidder's shares. The question was whether this pre-bid placement of the bidder's shares with institutions holding target company shares constituted a prohibited benefit.

Finkelstein J considered that two elements needed to be established under s 698(2):

- the provision of benefits
- those benefits being connected with, or having the potential to influence or induce, a decision to sell shares in the target company.

Provision of benefits

In relation to this element, the question was whether the issue of the bidder's shares to institutions holding target company shares provided a benefit to those institutions. Finkelstein J considered[11] that this sale conferred the following benefits on the purchasing institutional investors:

- the ability to acquire shares in the bidder without the payment of brokerage
- the ability to acquire a large parcel of these shares at one time
- the ability to acquire a large parcel of these shares without the need to purchase them on-market, thereby avoiding the risk of forcing up the price of those shares before the whole parcel could be purchased
- the ability to obtain an attractive investment
- the ability to acquire shares not otherwise available on the open market.

Benefit connected with, influencing or inducing a decision to sell target company shares

In relation to this element, His Honour considered that the sale of the bidder's shares to the institutional investors could influence or induce them to sell their shares in the target to the bidder.[12] He noted that one of the institutional investors in the pre-bid period sold a very large holding of target shares to the intending bidder and obtained an even larger holding of the bidder's shares. He found it hard to believe that the sale and the acquisition were not connected in a commercial sense. He said that:

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[11] At 222-223.
[12] At 221-222.

> "It is almost inevitable that those institutions that have subscribed for the issue [of bidder shares] will sell their [target] shares. They will do so to secure the success of the takeover and to maximise the number of [bidder] shares they will obtain."[13]

On this reasoning, Finkelstein J held that the sale of the bidder's shares to the institutions had induced those institutions to sell their target company shares to the bidder under the bid.

Implications

Before the *Aberfoyle* decision, many practitioners had taken the view that a placement of bidder's shares with institutional investors holding target company shares would not contravene s 698, as any benefits the institutional investors received would not be in their capacity as shareholders of the target.[14] Following *Aberfoyle*, the legality of such placements is in doubt.

It is arguable that the decision would not prevent a prospective bidder from raising funds for its bid by issuing its shares to institutions merely because some of them also hold target company shares. The *Aberfoyle* decision rests on a link being established between the bidder's shares being offered to the institutional investors and the desire of the bidder to acquire target company shares from those institutional investors. The problem of illegality clearly arises where that share issue is linked to the purchase of target company shares from the institutions.[15]

ASIC response

After the *Aberfoyle* decision, ASIC granted the bidder a modification to allow it to offer its own shares to those institutional investors that also held shares in the prospective target on the basis that:

- the intending bidder did not offer its shares to any institution that itself held more than 1% of the shares in the prospective target [ASIC has subsequently applied a 5% threshold for securities convertible into shares]
- the aggregate percentage holdings in the prospective target of all the institutional investors which took up shares in the intending bidder did not exceed 20% of the prospective target's issued shareholding.

Market participants have informed ASIC that the 1% condition in particular is unworkable in many situations. It can be extremely difficult, given the limited number of institutions in the Australian market, for an intending bidder to issue its shares to

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13 At 222.

14 This reasoning was based on the decisions in *Gantry Acquisition Corp v Parker & Parsley Petroleum Australia Pty Ltd* (1994) 14 ACSR 11 and *Ampolex Ltd v Mobil Exploration & Producing Australia Pty Ltd* (1996) 19 ACSR 354.

15 The need to establish this linkage is reflected in s 623(2) of the Corporate Law Economic Reform Program Bill 1998 which requires that the benefit be "likely to induce the other person … to accept an offer under the bid".

institutions if it cannot offer those shares to any institution that also holds shares in the prospective target.

ASIC is currently reviewing its policy for exercising its discretion to modify s 698 to facilitate placements of bidder shares with institutions.

Advice by the Legal Committee

The Advisory Committee at its 19 October 1998 meeting requested the Legal Committee to advise it on the various legal implications of the *Aberfoyle* decision.

The Legal Committee considered the *Aberfoyle* decision at its 13 November meeting, and forwarded its advice to the Advisory Committee for its 30 November meeting.

The Legal Committee members considered that the Government should not proceed with s 623(2) & (3) of the CLERP Bill (in effect, repealing s 698(2) & (4) of the Corporations Law). This would leave a prospective bidder free to acquire shares both on-market and off-market without restriction up to the 20% takeover threshold. The members confirmed the Legal Committee's recommendation in its *Takeovers Anomalies Report* (1994) that s 698(2) & (4) be repealed.

In support of not proceeding with s 623(2) & (3) of the CLERP Bill, the Legal Committee members made the following points.

- Provided that escalation clauses continue to be prohibited (CLERP Bill s 622), shareholders who sell in the pre-bid period take the risk of receiving a lower price than would be available under the takeover offer.

- The restrictions imposed by the *Aberfoyle* decision on the method of accumulating a shareholding base from which to launch a bid are inconsistent with the underlying principle that a person should have the right to acquire shares up to the takeover threshold.

- Not proceeding with s 623(2) & (3) of the CLERP Bill would avoid the problem highlighted by the *Aberfoyle* decision that early unconditional cash payment before a conditional cash bid is a prohibited benefit. The CLERP Bill s 623(4) does not solve the problem entirely. It would only apply to on-market pre-bid acquisitions. Also, "conditional bid" is not defined.

Not proceeding with s 623(2) & (3) of the CLERP Bill would have the additional advantage that it would no longer be necessary to modify the on-market transaction exemption in s 623(5)(b) to exempt ordinary crossings by brokers. The Legal Committee members agreed that if, contrary to their advice, s 623(2) & (3) of the CLERP Bill are proceeded with, ordinary crossings should be exempt. However, the members saw difficulty in defining an "on-market transaction" exemption for this purpose with sufficient precision to avoid litigation in a contested takeover, particularly if that exemption depended on a lack of pre-arrangement.

The Legal Committee members opposed any law reform that would provide an exemption from s 623(2) & (3) only for conditional bids that were limited to prescribed occurrence conditions. They considered that distinguishing between

prescribed occurrence and other conditional bids in this context was inappropriate, as the prescribed occurrence conditions did not include conditions based on movements in the market, which were generally essential conditions in takeover bids for quoted shares. This issue would not arise if s 623(2) & (3) were not proceed with.

Advisory Committee recommendation

The Advisory Committee considered this matter at its 30 November meeting. The members agreed with the Legal Committee that s 623(2) & (3) of the CLERP Bill should be omitted. They considered that these subsections have too broad and indefinite an application and are not necessary to protect the interests of offeree shareholders.

Recommendation

The Advisory Committee recommends that the Government not proceed with s 623(2) & (3) of the CLERP Bill.