Takeovers

Corporate control: a better environment for productive investment

Corporate Law Economic Reform Program

Proposals for Reform: Paper No. 4

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ABBREVIATIONS

ASC	Australian Securities Commission
ASX	Australian Stock Exchange
CASAC	Companies and Securities Advisory Committee
CLERP	Corporate Law Economic Reform Program
Code	City Code on Takeovers and Mergers (United Kingdom)
FSI	Financial System Inquiry
Panel	Corporations and Securities Panel

PART 1: REFORM PROPOSALS

PROPOSAL NO. 1 — EQUAL OPPORTUNITY

The equal opportunity principle should be retained. This would ensure that all shareholders of a target company have reasonable and equal opportunities to participate in any benefits under a change in corporate control.

PROPOSAL NO. 2 — MANDATORY BID RULE

Changes in corporate control could be facilitated by allowing acquisitions which would exceed the statutory threshold provided that the acquisition was immediately followed by the announcement of a full takeover bid. This would provide market participants with an additional mechanism to acquire and relinquish corporate control. The Government will consider whether a mandatory bid rule should be introduced in light of comments on this issue.

PROPOSAL NO. 3 — CONTENTS OF MANDATORY BID RULE

If a mandatory bid rule was introduced, the following conditions could apply:

- a bid for all the outstanding shares in the target must be announced immediately following the agreement which takes the bidder above the statutory threshold;
- the bid must be for an amount at least equivalent to the highest price paid by the bidder in the last four months;
- the bid must be for cash or, if scrip is offered, there must be a cash alternative of equivalent value; and
- the bid must be unconditional.

A person under an obligation to make a bid could be relieved from that obligation in exceptional circumstances by the Corporations and Securities Panel (Panel). The Government would consider whether the above conditions should apply, if a mandatory bid rule was introduced, in light of comments on this issue.

PROPOSAL NO. 4 — COMPULSORY ACQUISITIONS OF ALL SECURITIES IN THE RELEVANT CLASS

The current law allows compulsory acquisition of minority interests in certain circumstances. This should be expanded to facilitate the acquisition of the outstanding securities in a class by any person who already holds 90 per cent of the class. If 10 per cent by value of the minority security holders dissented, the acquisition would only be able to proceed with court approval of the fairness of the price.

Existing compulsory acquisition rules and procedures should be streamlined by:

- enabling takeover bids and post-bid compulsory acquisitions to be made for all classes of securities; and
- providing that post-bid compulsory acquisitions can proceed if the bid was accepted by the holders of 75 per cent by value of the outstanding securities (rather than by 75 per cent of the number of holders as currently required).

PROPOSAL NO. 5 — COMPULSORY ACQUISITIONS OF ALL SECURITIES IN THE COMPANY

The current law in relation to compulsory acquisition of minority interests could be expanded to facilitate the acquisition of 100 per cent of the shares or any securities convertible into shares of a company by any person holding at least 90 per cent by value of those shares and securities, provided that they also hold at least 90 per cent of the voting rights of the company. If 10 per cent by value of the minority security holders of any class dissented, the acquisition of that class would only be able to proceed with court approval of the fairness of the price. The Government will consider whether the compulsory acquisition provisions should be expanded in this manner in light of comments on this issue.

PROPOSAL NO. 6 — DISPUTE RESOLUTION

A reconstituted Panel should replace the courts as the primary forum for resolving takeover disputes under the Corporations Law, with the exception of civil claims after the takeover has occurred and criminal prosecutions. The Panel would enforce compliance with the spirit of the Law. All interested parties would be able to bring matters before the Panel, not just the Australian Securities Commission (ASC). Any aggrieved party would have a right of appeal from a Panel decision to an appeal division of the Panel. The courts would only be able to grant an injunction having the effect of delaying or stopping a bid on the application of the ASC. The capacity of the courts to review decisions of the Panel would be restricted.

PROPOSAL NO. 7 — TAKEOVERS OF LISTED MANAGED INVESTMENT SCHEMES

The takeover provisions of the Corporations Law, including the provisions on compulsory acquisitions and disclosure of substantial holdings, should apply to listed managed investment schemes subject to appropriate modifications. This would override any inconsistent takeover rules contained in the Australian Stock Exchange (ASX) Listing Rules or existing trust deeds.

PROPOSAL NO. 8 — REMOVING LISTED SCHEME MANAGERS

To be consistent with the ASX Listing Rules, the legislation should make it clear that the manager of a listed managed investment scheme is able to be replaced on the same basis as company directors, namely by a simple majority of unit holders who vote at a duly convened meeting (whether in person or by proxy).

PROPOSAL NO. 9 — OTHER CHANGES OF CONTROL OF LISTED MANAGED INVESTMENT SCHEMES

Changes in control of listed managed investment schemes by acquisition of the manager of the scheme or by acquisition of the management rights for the scheme should be approved by a simple majority at a unit holders' meeting.

PROPOSAL NO. 10 — SCHEMES OF ARRANGEMENT

The current approach to takeovers by scheme of arrangement should be retained. This would continue to allow schemes to be used to transfer control of a 'target' company to a 'bidder' company (by cancelling all of the shares in the target other than those held by the bidder), subject to the operation of the scheme provisions.

PROPOSAL NO. 11 — GOVERNMENTAL IMMUNITY

The Federal, State and Territory Governments and their business enterprises should be subject to the takeover provisions.

PART 2: INTRODUCTION

This paper is part of the Corporate Law Economic Reform Program (CLERP) which is examining the Corporations Law with a view to promoting business and economic development. The Program brings an economic focus to corporate law reform, and aims to ensure that the Corporations Law facilitates investment, while maintaining confidence in the business environment and protecting investors.

This paper sets out proposals for reform of takeover regulation under the Corporations Law. The reforms aim to remove regulatory impediments to an efficient market for corporate control subject to ensuring a sound investor protection regime.

The proposals have been developed in consultation with the helpful assistance of a broad range of individuals, companies and associations in the business and professional community and the Government's Business Regulation Advisory Group (see Appendix A).

Takeover regulation is one of the key areas identified for review and reform in view of its central importance to business activity. The proposed reforms are designed to:

- provide business with appropriate arrangements for the regulation of changes of corporate control; and
- achieve an appropriate balance between facilitating efficient management and control of organisations while ensuring a sound investor protection regime.

Takeover regulation under the Corporations Law aims to regulate *how* changes of corporate control take place, rather than *whether* certain takeovers should take place. As a result, the broader issue of mergers in the context of competition policy is outside the scope of this paper. Similarly, the examination of the specific rules designed to achieve foreign investment policy objectives or for industries such as the media, banking and insurance is also outside the scope of this paper.

This paper deals with a recommendation from the Financial System Inquiry (FSI), namely that takeover provisions should apply to public unit trusts.[1]

The paper on the rules governing fundraising by corporations released as part of CLERP proposed that section 52 of the *Trade Practices Act 1974* no longer apply to dealings in securities. In particular, that paper proposed that the defences contained in the Corporations Law regarding takeover documents should have full effect notwithstanding the Trade Practices Act.[2] The liability regime for takeover activity will be generally consistent with the liability regime adopted for fundraising activity.

It is intended that the previous work and consultations undertaken on takeovers as part of the Corporations Law Simplification Program will be taken into account in the drafting of the takeover provisions, to the extent that the previous work is consistent with CLERP initiatives. This includes consideration of the recommendations of the Legal Committee of the Companies and Securities Advisory Committee (CASAC) in their reports *Anomalies in the Takeover Provisions of the Corporations Law* (March 1994) and *Compulsory Acquisitions* (January 1996).

The issue of collective action taken by institutional investors will also be considered during the drafting stage. As a matter of policy, the takeover rules should not inappropriately affect the ability of institutional investors to make decisions relating to corporate governance issues. It has been argued that the current law inhibits institutional investors from participating fully in corporate governance issues, as an agreement to act collectively in relation to voting at a company meeting could trigger the takeover provisions.[3]

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1 *Financial System Inquiry Final Report*, March 1997, Recommendation 87.

2 *Fundraising*, Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 2, p 43.

3 This results from the operation of the concepts of ‘entitlement’, ‘relevant interest’ and ‘associate’: Corporations Law, sections 12, 34, 51(1), 64 and 609. The ASC released a Issues Paper entitled *Collective Action by Institutional Investors* in November 1996 (see also Media Release 96/262).

PART 3: MARKET EFFICIENCY AND CONFIDENCE

Takeovers are an integral part of the operation of equity markets and in turn the Australian economy. The benefits of takeovers, or the prospect of takeovers, to shareholders, the corporate sector and the economy include improved corporate efficiency and enhanced management discipline, leading ultimately to greater wealth creation.

The basic objective of takeover regulation is to improve market efficiency. Specifically, regulation is directed at achieving an appropriate balance between encouraging efficient management and ensuring a sound investor protection regime, particularly for minority investors. The Law is not aimed at assessing the merits of individual takeovers. All regulation involves some cost and it is essential to ensure that the benefits from regulation outweigh consequential costs.

Market Behaviour

The capital market allows the savings of individuals to be used by companies to promote economic growth through the production of goods and services. Shareholders receive a return on their investment in the form of capital growth, through the increased market value of the company's securities, and dividends paid to them by the company. The role of company directors and management is to maximise the return on the capital invested by the shareholders.

Takeovers promote efficiency in the capital market in a number of ways. The threat of takeover provides a strong incentive for company directors and management to use capital efficiently. A failure to use the company's assets efficiently would ultimately be reflected in the company not providing an adequate return on its capital, leading to an underperforming share price. These circumstances could lead to the company becoming a potential takeover target. In the event of a takeover, directors and management face the prospect of replacement by nominees of the new shareholders. The prospect of a takeover acts to overcome the principal-agent problems inherent in the separation of company ownership and control, for example, where it is impracticable or too costly for shareholders to ensure that directors act in their interests. It provides market-based incentives to encourage adequate corporate performance and provides a penalty where this is not achieved.

A takeover can promote efficient resource allocation where the control of the company's assets is transferred and the assets are put to a more productive use. Similarly, the new management may be able to improve productive efficiency of the company by making goods or services at a lower cost, for example, due to economies of scale or scope by integration with its existing operations. The new corporate ownership and control may also facilitate dynamic efficiency by making the company more responsive to changes in technology, creating opportunities for innovation or improved production processes. Prospective bidders monitor potential targets and bid for a company if they consider that they can profit from improving its management.

3.1 ADDRESSING INFORMATION IMBALANCES: DISCLOSURE

An efficient market relies upon two main interrelated factors: competition and information. Ideally, competition results in the price of securities being determined by supply and demand, with the price reflecting all available information at that time. This assumes that information is freely available and costless, and is immediately incorporated into market prices.

In the context of takeovers, competition promotes the efficient allocation of capital by providing an opportunity for the bidder offering the highest price for the company's shares to acquire its assets. This assumes that target shareholders will be able to make an informed decision on whether to sell and that the highest price will be paid by the person who can use the assets most efficiently.

Information is crucial to both efficiency and confidence in the market. As discussed above, an efficient market relies upon investors being able to make informed decisions about the securities that they buy and sell, so that the securities can be priced correctly. Investors will be reluctant to invest in the market if they consider that they may be disadvantaged by an inability to access information necessary to make informed decisions.

While a competitive and efficient market requires information to be readily available and costless so that it may be quickly incorporated into share prices, this is not always the case. Information imbalances occur where there is an imbalance of information available to market players (for example, between bidders and target shareholders). Information is often costly and difficult to acquire, evaluate and transfer to others. Subject to the insider trading provisions of the Corporations Law, possession of information can offer strategic advantages given the profits available to traders with more complete or accurate information on securities than the market.

The continuous disclosure and annual reporting requirements in the Corporations Law require the disclosure of price sensitive information and information concerning the company's financial position and performance. Annual reports may also contain information about the company's future prospects. However, this information alone is generally not sufficient to allow bidders and target shareholders to make informed decisions on questions of corporate control.

There is a disincentive for bidders to provide full disclosure to target shareholders concerning the bid, which may lead to information imbalances between the bidder and target shareholders. Prospective bidders can expend substantial resources identifying underpriced companies and determining how management can be improved. For example, the bidder may obtain their own valuation of target assets or analyse records maintained by the stock exchange, if the target is listed, or records held by the ASC, if the target is not listed.[4] These search costs may not be able to be recovered by the bidder, particularly if a rival bidder acquires the company. In such a case, the rival bidder will be able to 'free-ride' on the search costs paid by the initial bidder.

There may also be information imbalances on the seller's side. This occurs because the information which is required for target shareholders to make an informed decision is generally in the possession of the target company's directors rather than the shareholders, because of the directors' day-to-day control of the company's operations.[5]

Disclosure requirements can help address these information imbalances. It is important that target shareholders have access to sufficient information about the bid and know the identity of the bidder in order to determine whether the transaction would be optimal compared to alternative bids. Similarly, shareholders would be better able to make the best decision on whether to sell their shares where they have adequate time to consider the available information on the bid and the target company's shares.

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4 R Levy, *Takeovers, Law and Strategy*, LBC Information Services, 1996, at p 32.

5 E Von Thadden, 'On the Efficiency of the Market for Corporate Control', *KYKLOS*, Vol 43, Fasc 4, at pp 635-638.

These concerns are addressed in the Eggleston principles,[6] which provide the philosophical underpinning of the current takeover rules. The first three Eggleston principles require that:

- the bidder's identity be known to shareholders and directors of the target;
- shareholders and directors of the target have a reasonable time to consider the bid; and
- the bidder give sufficient information to the shareholders to enable them to form a judgement on the merits of the bid.

By requiring bidders to disclose information which is needed to make an informed decision on whether to accept the bid, target shareholders can make decisions which incorporate information known by the bidder about the bid and the target company. Similarly, requiring the target company's directors to provide information in the context of the bid would ensure that shareholders are given information about the target company which may not have been released as part of the continuous disclosure or other reporting requirements.

These disclosure requirements, however, have costs. Compliance costs are initially paid by the bidder and the target company, but these are ultimately borne by their respective shareholders. As indicated above, the disclosure of information can lead to rival bidders 'free-riding' on the information produced to the detriment of the initial bidder. This could be partly overcome by a mandatory bid procedure.[7]

Although there are costs of disclosure, they are clearly outweighed by the benefits of facilitating an efficient market and protecting investors.

3.2 MARKET CONFIDENCE: EQUAL OPPORTUNITY

Investor confidence is a crucial feature of efficient financial markets. It facilitates attracting the capital necessary for ensuring the liquidity required for an efficient capital market. A higher market turnover provides a more effective price mechanism as a result of the increased information available from increased transaction volume.

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6 They are named after the Chairman of the committee which recommended them: Company Law Advisory Committee *Report to the Standing Committee of Attorneys-General on Disclosure of Substantial Shareholdings and Takeovers*, 1969.

7 See Part 4.1.

Investor protection is a significant element contributing to market confidence. People will be less likely to invest directly in the capital market if they perceive that they are likely to receive lower returns because of insufficient information or a weak bargaining position. For example, shareholders may be disadvantaged where they are left as a minority following a change of corporate control. As a result, investors (particularly retail investors) may be more likely to invest where they have an opportunity to sell out where control of the company changes. This is recognised in the Law by the fourth Eggleston principle, known as the equal opportunity principle.

The equal opportunity principle requires that, as far as practicable, each shareholder should have an equal opportunity to participate in the benefits offered under a bid. This means that minority shareholders have the opportunity to sell their shares to a buyer at the same price as the controlling shareholder. Any premium above the market price of the shares that the bidder is prepared to pay to gain control of the company (‘the control premium’) must be offered to all shareholders. The principle is based upon fairness and encouraging investor confidence in the capital market.

The principle has been criticised on the basis that it impedes market freedom. Without the principle, shareholders would be able to negotiate private sales of control and to be the sole beneficiary of any premium paid. This issue highlights the dichotomy between the twin roles of regulation in this area: promoting economic efficiency on the one hand and encouraging investment through shareholder protection on the other.

Regulatory Framework

The equal opportunity principle is an integral element of the takeover provisions of the Corporations Law. It is implemented in the current law through the prohibition against acquiring shares above the takeover threshold unless a bid is made or a specific exception applies, a requirement for uniform offers and a prohibition on the giving of benefits outside a bid.[8] Even if there is no breach of the takeover provisions, depriving shareholders of an equal opportunity to participate in benefits accruing from a bid may constitute ‘unacceptable circumstances’, leading to a referral to the Panel.[9]

8 Corporations Law, sections 615, 636 and 698.
9 Corporations Law, sections 732 and 733.

Overseas Experience

In the United Kingdom, takeovers are regulated by a private code and legislation. The United Kingdom Code on Takeovers and Mergers (the Code) and the associated Rules Governing Substantial Acquisitions of Shares operate in tandem with legislation governing compulsory acquisitions and compromises and arrangements. The Code consists of general principles and rules of conduct requiring full disclosure of relevant information and equal treatment of shareholders. This philosophy is consistent with the Eggleston principles which underpin the takeover provisions in the Corporations Law.

Across Europe, there are differing regulatory regimes for takeovers reflecting the variations in conditions for and frequency of takeovers in individual countries.[10] Consistent with its practice, the European Community has been exploring the introduction of uniform standards. The draft European Community directive on takeovers sets out general principles and minimum requirements for the conduct of certain takeover bids, which Member States would have to implement through more detailed rules.[11] Rules made in accordance with the draft directive would be required to comply with five general principles, which include that target security holders who are in the same position must be treated equally.[12] The draft directive would also require Member States to include an obligation to make a bid, or offer other appropriate and at least equivalent means in order to protect minority shareholders, where a person acquires a certain percentage of voting rights which confers control of the company.[13]

In New Zealand, takeovers are primarily regulated by a combination of the Listing Rules of the New Zealand Stock Exchange and the *Companies Amendment Act 1963*. The Listing Rules permit companies to incorporate into their constitution one of three sets of takeover rules, including a set which is

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10 See paragraph 5 of the Explanatory Memorandum accompanying the *Proposal for a Thirteenth Directive on Company Law Concerning Takeover Bids*, April 1996; N S Poser, *International Securities Regulation*, Little, Brown and Company, 1991, pp 367-368.

11 The draft directive would apply to companies which are traded on a public stock exchange within the Community: see *Proposal for a Thirteenth Directive on Company Law Concerning Takeover Bids*, April 1996, article 1.

12 The remaining principles concern giving target security holders sufficient time and information to reach a properly informed decision on the bid, the target board acting in the interests of the company, the disclosure of information to avoid false markets in securities and target companies not being hindered by a bid any longer than is reasonable: *Proposal for a Thirteenth Directive on Company Law Concerning Takeover Bids*, April 1996, article 5.

13 The percentage threshold could vary as it would be determined by each country: *Proposal for a Thirteenth Directive on Company Law Concerning Takeover Bids*, April 1996, article 3.

based on equality of opportunity. Like the Eggleston principles, the object of the Companies Amendment Act is the protection of investors by ensuring they have sufficient time and information to make a decision as to whether to accept a takeover offer. However, there is no equivalent to the equal opportunity principle as it operates in Australia.[14]

In the United States, takeovers are regulated by the Federal *Securities Exchange Act 1934*, as amended by the *Williams Act 1968*, and State laws. While the State laws are generally aimed at deterring takeovers in order to protect incumbent management and employees in the target company, the Federal law is essentially disclosure based, requiring shareholders to be provided with information to make an informed decision about whether to accept an offer to purchase shares.[15] Unlike the Corporations Law provisions, there is no underlying equality of opportunity principle. While equality of treatment is required where an offer is made to investors at large, control can pass in private transactions without such an offer being made. In practice, offers will often be made to investors at large for a variety of reasons, including obligations under State statutes and to avoid litigation from minority shareholders.

Takeovers are regulated in Canada by both Provincial legislation and the Federal *Canada Business Corporations Act 1985* (CBCA), which is based upon the takeover provisions of the Ontario *Securities Act 1990*. The CBCA regulates, among other things, disclosure of material information necessary for target shareholders to make an informed decision. Where in effect control is acquired from five or more shareholders and a premium of more than 15 per cent is paid, an offer must be made to all shareholders.[16]

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14 The New Zealand *Takeovers Act 1993* establishes a Takeovers Panel for the purpose of formulating and recommending a proposed takeovers code. If approved, the code would have the effect of a statutory regulation. Objectives to be considered in formulating the code include ensuring that security holders are treated fairly, uniform offers are made to all security holders, and that security holders have the same opportunity for acceptance: *Takeovers Act 1993*, paragraphs 20(1)(c) and 21(c). However, enactment of the code was indefinitely postponed by the New Zealand Government in August 1995.

15 The *Securities Exchange Act 1934* requires disclosure of the identity of the bidder, information with respect to dealings with the target within a three year period prior to the bid, the source and amount of funds needed to complete the offer and other information about the bidder and its intentions regarding the target: section 14(d) and Schedule 14D-1.

16 Ontario *Securities Act 1990*, sections 93(1)(c) and 89(1).

Importance of the Equal Opportunity Principle

The objective underlying the equal opportunity principle is the protection of minority shareholders by giving them reasonable and equal opportunities to participate in changes of corporate control. Without the investor protection provided by the equal opportunity principle, it may be less likely that smaller investors would invest directly in the market, which could affect market liquidity and confidence. However, there are a number of other factors which affect market confidence, including the general economic conditions and regulatory rules.

Investor Confidence

Under the current law, an advantage of share ownership as a form of investment is the opportunity to share in the distribution of the economic benefits deriving from transfers of corporate control, that is, any premium paid by the bidder. If the equal opportunity principle did not apply, non-controlling shareholders in the target company, who may lack the bargaining power that larger shareholders possess, would not have an opportunity to share in the premium. In addition, where a control parcel was sought by acquisitions from the market at large, the price which an individual shareholder would be able to obtain may depend upon the speed with which they sell their holding. This would weaken shareholder protection which may impact on investor confidence in the capital market.[17]

Investment Risk

Where investors are risk averse, they may prefer an equal opportunity to participate in a change of control to the risk of higher or lower returns from a new purchaser of control.[18] Following the sale of the controlling shares, the target company may be managed in a way which is detrimental to the interests of the remaining shareholders.

Without the equal opportunity principle, there could be differential treatment of shareholders. Control could pass without some shareholders having any opportunity to sell their shares at the likely higher price. In addition, the

17 A possible result would be a decline in retail investment and an increase in managed investment, with managers monitoring market activity in return for management fees (see Part 5.1).

18 R W Hamilton, ‘Private Sale of Control Transactions: where we stand today’, 36 *Case-Western Res Law Review*, p 248 at 258.

change in control could result in a reduction in the market value of the shares, depressing the price which minority shareholders could receive. A bidder could acquire control of all of the business and assets of the target at a price significantly less than the full value of the target. This would particularly be the case in a partial on-market bid where the bidder bought sufficient shares to deliver control in a short time period.

The risk of becoming a minority shareholder unable to sell their shares at the pre-takeover price or receiving lower returns from a new purchaser of control may be able to be minimised through an investor diversifying their funds between different companies or assets. However, from an investor's perspective this would be a second best alternative to the equal opportunity principle as, in practical terms, diversification can be difficult to achieve without incurring substantial costs, especially if the investor does not have liquid investments.[19] Alternatively, investors could move to managed investments, leading to less direct investment in the capital market.

Costs of the Equal Opportunity Principle

The equal opportunity principle potentially creates higher costs for market participants, reducing incentives to engage in takeover activity. Without the principle, takeover costs could be lower, thereby increasing incentives to bid for a target company and leading to greater efficiency through the prospect of increased takeover activity.[20]

Under the equal opportunity principle, the total consideration paid by the bidder could increase as a result of the need to make offers to all shareholders instead of those necessary to obtain control. Making the offer price sufficiently attractive to larger shareholders may also increase the total consideration paid. Alternatively, the principle could result in a lower premium obtainable by controlling shareholders, where the bidder decides to pay the same total premium and distribute it amongst all target shareholders.

Controlling shareholders in the target may consequently receive a smaller percentage of the premium than that reflecting the control inherent in a large shareholding. In this respect, the current law allows holders of smaller parcels of shares to gain a windfall, free-riding on the endeavours of controlling shareholders. However, it is likely that the effect of the equal opportunity

19 R W Hamilton, 'Private Sale of Control Transactions: where we stand today', 36 *Case-Western Res Law Review*, p 248 at 258.

20 See 'Market Behaviour' in Part 3.

principle is already taken into account by shareholders when acquiring control parcels.

Retaining the Equal Opportunity Principle

While the equal opportunity principle may reduce incentives to engage in a takeover, whether as a potential bidder or a controlling target shareholder, the principle promotes investor and market confidence.

The regimes in key overseas jurisdictions, although not including an equal opportunity principle as it currently applies in Australia, encourage equal treatment of shareholders to varying extents. Not having equal treatment of shareholders could adversely affect the reputation of our capital market.

In the absence of strong evidence to the contrary, it would appear that the potential benefits of the principle exceed the potential costs. While market inefficiencies arising from the current law may add costs to takeovers, reducing incentives to bid or sell into a bid, any costs could be offset by gains in other areas. For example, a mandatory bid procedure could be introduced, where bidders would be able to acquire control in a pre-bid transaction.[21] This could reduce costs for bidders and facilitate efficiency in potential target companies.

The equal opportunity principle enhances aspects of the market that are essential: market integrity and investor protection. These are important elements of the aims of Australia's corporate law regime, namely encouraging companies to facilitate investment, employment and wealth creation, while protecting investors and maintaining confidence in the securities market. The benefits to be gained from the equal opportunity principle further this policy objective.

Policy Framework for Takeover Regulation

The above analysis suggests that regulating takeovers in general can be justified on the following grounds:

- requiring disclosure to promote an efficient market; and

21 See Part 4.1.

- providing investor protection to maintain investor and market confidence.

Specific rules which are proposed should be carefully considered in terms of their costs and benefits to ensure that the regulation is appropriate and does not impose unnecessary transaction costs.

Proposal No. 1 — Equal Opportunity

The equal opportunity principle should be retained. This would ensure that all shareholders of a target company have reasonable and equal opportunities to participate in any benefits under a change in corporate control.

PART 4: REDUCING TRANSACTION COSTS

4.1 MANDATORY BID

It has been argued that the current takeover provisions discourage bids by requiring 'auctions' for corporate control. Comments are being sought on whether a more efficient approach would be to permit control to change hands in private and other non-bid transactions, provided that a bid is subsequently made on comparable terms.

Regulatory Framework

Currently, the takeover provisions are based on a prohibition against acquiring shares above a statutory threshold of 20 per cent of the voting shares in a target company, subject to a number of exceptions.[22] The principal exception is the making of a takeover offer which complies with the takeover scheme or announcement provisions.[23]

As a result, control of a company passes after a formal takeover offer is made. The provisions have the effect of preventing attempts to acquire control prior to the making of a takeover offer. For example, pre-bid agreements or understandings between bidders and target shareholders are prohibited, where they would operate to take the bidder over the statutory threshold.[24]

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22 Corporations Law, section 615.

23 Corporations Law, sections 616 and 617.

24 The prohibition in section 615 of the Corporations Law has a broad operation through the concepts of 'entitlement', 'relevant interest' and 'associate': Corporations Law, sections 12, 34, 51(1), 64 and 609. However, some commentators argue that informal understandings between bidders and target shareholders to purchase control occur in practice. At the very least, it is generally accepted that bidders usually approach a target to gauge likely reaction to a takeover before any bid is announced. Currently, an ASC policy facilitating sales by tender of control parcels has the effect of requiring a mandatory bid and allowing control to pass prior to the bid: ASC Policy Statement 102, *Tender offers by vendor shareholders*, 2 October 1995.

Facilitating Auctions for Control

By generally precluding control from changing hands other than during a bid, the takeover provisions facilitate auctions for corporate control. In particular, the provisions requiring disclosure concerning the offer, minimum offer periods and a minimum period between the announcement and opening of an offer[25] make it possible for other parties to contest the bid by offering a higher price.

Target directors may encourage an auction for control by seeking rival bidders after a takeover bid is announced. Such behaviour by target directors may be viewed as a defensive tactic intended to frustrate a pending takeover by cooperating with a ‘friendly’ rival bidder. On the other hand, target directors may be acting to maximise shareholder wealth, particularly in response to an inadequate offer price.

Overseas Experience

There is experience of direct relevance in the United Kingdom, where the Code includes a mandatory bid requirement.[26] Where a bidder and its associates acquire 30 per cent or more of a target company the bidder must make a bid for the remaining shares.[27] The bidder must make an announcement of the offer immediately upon the acquisition of shares above the 30 per cent threshold. That offer must at least be equivalent to the highest price paid by the bidder in the last 12 months.

The majority of bids in the United Kingdom are not mandatory ones but rather are voluntary bids where the bidder has not initially exceeded the threshold. The Panel on Takeovers and Mergers has imposed rigorous rules in relation to mandatory bids including restrictions on conditions which would defeat the bid.

25 Corporations Law, sections 750, 638(3) and 674(1).

26 Canada has had limited experience with a mandatory bid rule but not in the context of a generalised equality of opportunity principle. Mandatory bids were a feature of the Ontario Securities Act from 1979 to 1987 but the requirement did not apply where control was purchased from a single shareholder or a small number of shareholders.

27 *City Code on Takeovers and Mergers*, rule 9. Under General Principle 10 of the Code, the parties must, before acquiring control of a company, ensure that they are able to make the required offer to all other shareholders.

Costs of a Mandatory Bid

The principal cost of a mandatory bid rule is the possible adverse impact on a competitive market for corporate control by reducing the opportunity for auctions for control.

Under a mandatory bid, control could pass prior to the making of a formal takeover bid. This would preclude rival bids and the opportunity for an auction for control. An auction facilitates price competition in the market by compelling a bidder to pay an amount at least as high as others are, or might be, willing to pay. In the absence of this competition, it is argued that bidders may acquire targets for a lower premium,[28] harming the interests of target shareholders by depriving them of the 'true' value of their shares.

The auction process may also facilitate the efficient transfer of assets to their most efficient use. If there is an auction, rivals to the original bidder who are able to use the assets more efficiently will have the opportunity to offer a higher price. In theory, the person who can use assets most efficiently will be prepared to pay the highest price. If control is allowed to change hands without the opportunity for an auction, the first bidder who offers enough to acquire a controlling stake will obtain the asset even if they are not the most efficient user of it.

Benefits of a Mandatory Bid

There are potentially significant benefits associated with introducing a mandatory bid, including:

- *increasing certainty as to the outcome of a bid* — it has been suggested that potential bidders are discouraged by the current law and are reluctant to make bids due to the risk of being involved in a bidding war or being an unsuccessful bidder. As potential bidders are unable to confidently secure control in advance of a bid, uncertainty as to the outcome of a bid dampens incentives to launch takeovers. The main advantage of the mandatory bid is that it would recognise pre-bid agreements between potential bidders and interested target shareholders and thus promote certainty in the takeover process;

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28 This is particularly relevant in the case of the 'anxious seller' who may not be concerned with gaining the maximum price possible from the purchaser. See also, L Bebchuk, 'The Case for Facilitating Competing Tender Offers' (1982) 95 *Harvard Law Review*, p 1028 at 1043.

- *lower bid costs* — an auction potentially leads to an increased takeover premium, adding significant costs to a bid. This may discourage prospective bidders of other targets who will expect higher bid prices.[29] However, it should be recognised that there is little empirical data directly demonstrating the existence, magnitude and impact of costs allegedly created by auctions for corporate control;[30] and
- *smoother bid process* ¾ there is currently concern that directors of the target company may facilitate an auction for control by seeking rival bidders after a takeover bid is announced as a defensive tactic to frustrate a bid. Defensive behaviour can be considered to be a market inefficiency through the inefficient use of corporate resources and may deprive target shareholders of a takeover premium if the bid is frustrated.[31]

A mandatory bid rule should not decrease price competitiveness in the market for corporate control. Although under a mandatory bid the price is struck between the buyer and the seller in a single transaction, and not by a series of bids as it is in an auction, it would be in the interests of the seller to get the best price possible for the control parcel. While it is difficult to assess the magnitude of the 'anxious seller' problem, where the seller is anxious to sell rather than to get the best possible price for the shares, it is likely that, in light of the ability to sell their parcel in advance of a bid, controlling shareholders would inform themselves about the value of their parcel and negotiate the best price. In practice, it is likely that a significant parcel of shares in a company would attract bids from more than one buyer and that these would include a premium for control, which under a mandatory bid rule would be offered to all other shareholders.

Discourage 'Free-Riding'

A mandatory bid would reduce the opportunity for subsequent bidders to 'free-ride' on the endeavours of an initial bidder.

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29 F H Easterbrook and D R Fischel, 'The Proper Role of a Target's Management in Responding to a Takeover Offer' (1981) 94 *Harvard Law Review*, p 1161 at 1177. Auctions can also lead to an uncertainty cost in that a bidder may initially under bid with the expectation that an auction would increase the bid price to an amount reflecting the value of the assets to the bidder.

30 Some writers point to the high level of takeover activity in the United States, where defensive auctions are conducted, to show that auxiliary costs do not inhibit the launch of bids. See, for example, L Bebchuk, 'The Case for Facilitating Competing Tender Offers' (1982) 95 *Harvard Law Review*, p 1028 at 1036-1038.

31 B Banoff, 'The Securities Commission's Takeover Proposals: A 'Law and Economics' Perspective', (1985) *Canterbury Law Review*, Vol 2, No. 3, at p 308.

The initial bidder incurs costs in identifying potential targets, investigating their affairs and determining how their management can be improved. Rival bidders may use the information disclosed by the initial bidder under the takeover provisions to identify and bid for potential targets. If an auction ensues, the initial bidder is unable to recover these costs. Rival bidders become 'free-riders', using the information produced by the initial bidder and avoiding the search costs that the initial bidder bears.[32] This can result in reduced incentives to engage in searching for potential targets and in less investment in information producing activities.

Whether a Mandatory Bid Rule Should be Introduced

Comments are being sought on whether a mandatory bid rule should be introduced. This could allow control to pass in advance of a general offer being made, as an alternative to the current approach of making a voluntary bid before exceeding the statutory threshold. While the removal of an auction may result in some reduction of market transparency and smaller premiums being paid in some instances, it could be expected that more bids could take place as a result of greater certainty of outcome, providing greater incentives for efficient management under the increased prospect of a takeover.

Consistent with the experience in the United Kingdom, it could be expected that a significant number of voluntary bids would still take place leading to the possibility of auctions. This would largely depend on the content of the mandatory and voluntary bid rules and the circumstances of the bidder and target.

Proposal No. 2 — Mandatory Bid Rule

Changes in corporate control could be facilitated by allowing acquisitions which would exceed the statutory threshold provided that the acquisition was immediately followed by the announcement of a full takeover bid. This would provide market participants with an additional mechanism to acquire and relinquish corporate control. The Government will consider whether a mandatory bid rule should be introduced in light of comments on this issue.

32 Easterbrook and Fischel argue that the auction process in tandem with mandatory disclosure has contributed to reduced takeover activity: F H Easterbrook and D R Fischel, 'Auctions and Sunk Costs in Tender Offers' [1982] 35 *Stanford Law Review*, p 1.

Contents of Mandatory Bid Rule

If a mandatory bid rule was introduced, the regulatory rules would need to take into account the fact that control could already have passed at the time the mandatory bid is made to the target shareholders. Moreover, if the equality of opportunity principle is to be retained, the mandatory bid rules would need to be consistent with this principle as far as practicable. This suggests that:

- target shareholders would need to be given a fair opportunity to exit the company completely; and
- both the bidder and the target (which would be effectively controlled by the bidder) must not be permitted to do anything which would tend to defeat the bid.

A similar philosophy appears to underpin the mandatory bid rules which operate in the United Kingdom. There the bidder must in effect offer cash, with conditions generally not permitted.[33] The danger with allowing scrip only bids after control has passed is that, while the scrip may be attractive to those who sold to the bidder, it may not be similarly valued by other shareholders (who may not be able to dispose of it at a price equivalent to the value derived by those who sold). A scrip offer could also effectively result in ownership in the bidder, which would not give minority shareholders an opportunity to exit the company completely. Similarly, the risk with allowing the mandatory bid to be made on a conditional basis is that, if the conditions are not met, the bidder will have acquired control but minority shareholders would have lost the opportunity to dispose of their interests.

It would also be necessary to ensure that the mandatory bid rules do not leave the bidder, where it does not immediately exercise control over the target, in a position of having to complete a bid for an entity which is substantially different from that of which the bidder initially acquired control. For instance, significant share issues or a sale of the major undertakings of the target would need to be avoided. In order to ensure that the interests of the bidder are protected, the Panel would need to be able to relieve persons from the obligation to proceed with the mandatory bid. It could be expected that this would only occur in exceptional circumstances.

33 The only permitted condition is 50 per cent acceptance (this condition is required to be included in mandatory bids): *City Code on Takeovers and Mergers*, rule 9.3.

Proposal No. 3 — Contents of Mandatory Bid Rule

If a mandatory bid rule was introduced, the following conditions could apply:

- a bid for all the outstanding shares in the target must be announced immediately following the agreement which takes the bidder above the statutory threshold;
- the bid must be for an amount at least equivalent to the highest price paid by the bidder in the last four months;[34]
- the bid must be for cash or, if scrip is offered, there must be a cash alternative of equivalent value; and
- the bid must be unconditional.

A person under an obligation to make a bid could be relieved from that obligation in exceptional circumstances by the Panel. The Government would consider whether the above conditions should apply, if a mandatory bid rule was introduced, in light of comments on this issue.

4.2 COMPULSORY ACQUISITIONS

The current compulsory acquisition rules may not operate satisfactorily where there are different classes of securities. Furthermore, judicial decisions have led to concern about the effectiveness of the current compulsory acquisition mechanisms.

Regulatory Framework

Generally, a bidder who acquires 90 per cent or more of a company's shares under a takeover bid can compulsorily acquire the remaining shares on the same terms as the bid, provided 75 per cent by number of the outstanding shareholders sell their shares during the bid.[35] If the takeover relates to a particular class of shares then it is only the remainder of that class that may be acquired. The compulsory acquisition rights do not extend to classes of shares

34 This is consistent with the requirements in sections 641 and 698 of the Corporations Law, which are designed to ensure that the equal opportunity principle is not avoided by paying a higher price to a shareholder immediately before the bid.

35 Corporations Law, paragraph 701(2)(c).

that were not the subject of the bid, nor to securities other than shares (for example, options to acquire shares).

If a shareholder whose shares the bidder wishes to compulsorily acquire does not accept the terms of the acquisition, they may apply to the Court to exercise its discretion to order that the acquisition not occur.[36] The courts have held that the shareholder bears the onus of proving that the terms of the takeover offer are unfair, which will be particularly difficult to establish if a large number of shareholders have accepted the bid. The discretion is rarely exercised.[37]

Conversely, shareholders who did not accept the takeover offer may nevertheless opt to require the bidder to acquire their shares. The terms of the acquisition are the terms applying under the bid, terms as agreed between the shareholder and bidder, or terms declared by the Court on the application of either party. Further, if the bidder acquires at least 90 per cent of the *voting* shares in the company, any holder of renounceable options, convertible notes (neither of which the *bidder* could compulsorily acquire) or non-voting shares can compel the bidder to acquire them at an agreed price or a price set by the Court.[38] The Law does not provide a formula for the courts to use in setting the price of shares or other securities, and they have exercised their wide discretion reasonably favourably to bidders.[39]

For offers outside the scope of the takeover provisions (including where a bidder starts with 90 per cent ownership), there are special provisions for compulsory acquisition where 90 per cent of the offerees have agreed to sell their shares to the offeror.[40] A shareholder can apply to the courts to exercise their general discretion to grant an order preventing the acquisition.[41] Minority shareholders can also compel the offeror to accept their shares on the same terms as the offer or on such other terms as are mutually agreed or as the

36 Corporations Law, subsection 701(6).

37 An example of where it might be exercised is if the main body of shareholders were misled to sell at an undervalue: see CASAC, *Report by the Legal Committee on Compulsory Acquisitions ¾ 1996* at paragraphs 2.74-2.75.

38 Corporations Law, subsections 703(4) and (8) in particular.

39 See, for example, *Kingston v Keprose Pty Ltd (No 2)* (1987) 6 ACLC 111; 12 ACLR 599 and *Mercantile Mutual Life Insurance Co Ltd v Actraint No 85 Pty Ltd (No 2)* (1990) 52 SASR 506.

40 Shares held by the offeror or nominee are excluded from consideration, but if their nominal value exceeds 10 per cent of the total nominal value of all shares the subject of the offer, the compulsory acquisition provisions will only apply if 75 per cent of the other holders of the shares approve the offer and the terms of the offer are the same for each of them: Corporations Law, subsection 414(5).

41 Corporations Law, subsection 414(3).

Court determines (on the application of either party).[42] Again, the Law does not provide guidance as to the calculation of a fair price in cases in which the parties do not agree.

Compulsory acquisitions are also possible under other provisions of the Law, including those relating to capital reductions and schemes of arrangement.[43]

Benefits of 100 Per Cent Ownership

A takeover offer that achieves broad acceptance usually results in the bidder obtaining control of the target company. However, this is unlikely to result in the bidder achieving 100 per cent ownership of the company as some holders of securities may consider it is not in their best interests to accept the offer or may be uncontactable. It is common practice for a company to engage in takeover activity only if it is reasonably certain that it will be able to achieve 100 per cent ownership. The main advantages of 100 per cent ownership are:

- access to group tax loss treatment under section 80G of the *Income Tax Assessment Act 1936*; and
- direct access to the cash flows of the target.[44]

Justification for Compulsory Acquisition Rules

Once a person has acquired an overwhelming interest in a company, the law should facilitate compulsory acquisition of the remaining shares if the overwhelming owner wants to obtain the significant benefits of 100 per cent control (referred to above). An alternative view is that shareholders should be free to negotiate the disposal price of their shares and that market forces should be allowed to operate freely, even if this gives the last group of shareholders an opportunity to demand a large premium for selling the shares that will deliver 100 per cent ownership. However, such practices would also distort the market. If obtaining 100 per cent control was imperative to the bidder, it could encourage greenmailing (shareholders holding out in the hope of attracting a significantly better price). In cases where the bidder was not seeking 100 per cent control, it could encourage shareholders to sell merely to

42 Corporations Law, subsections 414(9)-(10).
43 See Part 5.2.
44 Other advantages include the avoidance of minority shareholder actions alleging oppression and reduction of administrative costs (for example, through group accounting and reduced secretarial costs).

avoid the risk of being trapped in a small minority and unable to dispose of their securities.

The gains in market efficiency from 100 per cent control and the protection of minority shareholders from being locked into the company justify compulsory acquisition rules. The rules preventing compulsory acquisition at an unfair value provide sufficient recognition of the minority shareholders' property rights.[45]

Proposed Reform

Changes are warranted to give full effect to the policy underlying the compulsory acquisition provisions. Impediments to acquiring 100 per cent of a company on fair terms need to be overcome to reduce transaction costs for the bidder and facilitate the efficiency gains from 100 per cent control.

Streamlining Existing Compulsory Acquisition Procedures

The existing compulsory acquisition procedures should be reformed as follows:

- Takeover bids should be able to be made for all securities, not just shares: if the necessary threshold is reached, compulsory acquisition would be available. The bidder would need to bid for each class of securities separately if they wished to acquire them. To complement this rule, persons holding securities which are not convertible into securities of a class which have been bid for would no longer be able to compel the bidder to acquire them.

- The 75 per cent rules should be changed to be based on the value of shares subject to acquisition under the takeover, rather than numbers of shareholders. This would overcome the potential problem of a single shareholding being distributed among several people to deliberately increase the number of shareholders able to oppose the bid.[46]

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45 This accords with the view reached by CASAC, *Report by the Legal Committee on Compulsory Acquisitions ¾ 1996* at paragraphs 1.11-1.18.

46 The ASC has exercised its discretionary power under section 730 of the Law to obviate the effect of share splitting: ASC Instruments 95/1848 and 96/1507 (see also Media Releases 96/92 and 96/172).

- Where a court considers the fairness of the compulsory acquisition price in the context of determining whether to disallow the acquisition, it should be required, firstly, to assess the value of the company as a whole and determine the value of each class of issued security (taking into account its relative financial risk and its distribution rights) and, secondly, to proportion that value to the remaining securities without any premium or discount.

- the controlling shareholder will pay its court costs and will generally also pay the costs of the dissenting shareholders.

These proposals accord with the recommendations proposed by the CASAC Legal Committee in *Report by the Legal Committee on Compulsory Acquisitions ¾ 1996*.[47]

New Compulsory Acquisition Procedure

In addition to these reforms, a new compulsory acquisition power needs to be introduced to ensure, in the interests of economic efficiency, that a person who acquires overwhelming ownership of a class of securities is able to achieve 100 per cent control of that class. This power would also help companies overcome any limitations on acquisitions flowing from the *Gambotto* decision.[48]

A new compulsory acquisition power should be introduced, and be available for any class of securities. It would apply whether or not a takeover bid has been made. A person with a full beneficial interest amounting to at least 90 per cent by value of any particular class of securities would be able to compulsorily acquire the remaining securities of that class. The procedure would involve the following:

- identical unconditional cash offers must be made to all outstanding shareholders;

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47 A range of other procedural and minor reforms recommended by CASAC will also be implemented (see paragraphs 2.62-2.73, 2.93-2.94 and 3.21-3.27 of the report). A number of CASAC recommendations relating to acquisitions under other procedures in the Law will be addressed as part of other legislative reforms, including other legislative proposals arising out of CLERP. Reforms to the compulsory acquisition procedures addressed in this paper (including statutory guidance on fair value) will be applied to the Law's other acquisition procedures as appropriate.

48 *Gambotto v W.C.P. Limited* (1995) 182 CLR 432, which has given rise to concerns that the exercise of compulsory acquisition powers is subject to a proper purpose test which does not permit a majority shareholder to remove the minorities in order to obtain the benefits of 100 per cent ownership.

- the offer must be accompanied by at least one independent expert's report on whether the offer is fair (applying the criteria referred to above);
- if fewer than 10 per cent (by value) of the outstanding holders dissent, the acquisition proceeds;
- if 10 per cent (by value) or more of the outstanding holders dissent, the controlling shareholder must either withdraw the offer or commence court proceedings;
- the court's role would be confined to approving or not approving compulsory acquisition of all the outstanding securities, solely on the basis of whether or not the price is fair; and
- the controlling shareholder would pay its court costs and would generally also pay the costs of the dissenting shareholders.

This is consistent with the approach recommended by the CASAC Legal Committee.[49]

Proposal No. 4 — Compulsory Acquisitions of all Securities in the Relevant Class

The current law allows compulsory acquisition of minority interests in certain circumstances. This should be expanded to facilitate the acquisition of the outstanding securities in a class by any person who already holds 90 per cent of the class. If 10 per cent by value of the minority security holders dissented, the acquisition would only be able to proceed with court approval of the fairness of the price.

Existing compulsory acquisition rules and procedures should be streamlined by:

- enabling takeover bids and post-bid compulsory acquisitions to be made for all classes of securities; and
- providing that post-bid compulsory acquisitions can proceed if the bid was accepted by the holders of 75 per cent by value of the outstanding securities (rather than by 75 per cent of the number of holders as currently required).

49 See CASAC, *Report by the Legal Committee on Compulsory Acquisitions ¾ 1996* at paragraphs 10.1-10.40.

Additional Compulsory Acquisition Procedure

In the interests of economic efficiency, it may be that a person who acquires overwhelming ownership of a company should be allowed to achieve 100 per cent control of *all classes* of the company's securities in order to access the full benefits of 100 per cent control. While the new power proposed above will enable compulsory acquisition in many non-bid situations, it does not deal with cases where the controlling shareholder is unable to reach the compulsory acquisition threshold in respect of one or more classes of securities (of which there may be many) or is ineligible to hold certain types of securities (for example, securities issued under employee share schemes).

To accommodate these cases, consideration could be given to introducing another compulsory acquisition power which would allow any remaining shares and any securities convertible into shares to be acquired by a person who has the full beneficial ownership of shares and convertible securities valued at 90 per cent of the total market value of the company. The CASAC Legal Committee considered in 1996 a power allowing a person to acquire all remaining classes of securities where the person obtains 90 per cent of the value of the company and was supportive of an approach along these lines.[50]

As an additional safeguard, the power could also be limited to persons who have a full beneficial entitlement to 90 per cent of the voting rights to approve a general resolution in a general meeting. This power would be exercised using similar procedures to the new power proposed above, including being subject to the possibility of challenge on the basis of the fairness of the price.

Proposal No. 5 — Compulsory Acquisitions of all Securities in the Company

The current law in relation to compulsory acquisition of minority interests could be expanded to facilitate the acquisition of 100 per cent of the shares or any securities convertible into shares of a company by any person holding at least 90 per cent by value of those shares and securities, provided that they also hold at least 90 per cent of the voting rights of the company. If 10 per cent by value of the minority security holders of any class dissented, the acquisition of that class would only be able to proceed with court approval of

50 The new power is also broadly consistent with an additional recommendation by CASAC for greater flexibility where the compulsory acquisition threshold has not been reached, although CASAC proposed giving the Court a general discretion (see CASAC, *Report by the Legal Committee on Compulsory Acquisitions ¾ 1996* at paragraphs 2.59-2.61).

the fairness of the price. The Government will consider whether the compulsory acquisition provisions should be expanded in this manner in light of comments on this issue.

4.3 Dispute Resolution

Targets in hostile takeover bids often resort to litigation which can result in bids being delayed, sometimes for tactical reasons. Such disputes are currently resolved by the courts. A specialist Panel was established in 1991 to carry out a limited role in the resolution of takeover disputes. Its jurisdiction depends upon referrals from the ASC and there have been only three to date. Hence the courts have been the principal forum for resolving takeover disputes.

The advantages of an effective panel for dispute resolution include:

- specialist expertise, with representation from industry as well as specialist lawyers;
- speed, informality and uniformity in decision making;
- the minimisation of tactical litigation; and
- the freeing up of court resources to attend to other priorities.

In the United Kingdom, which has the greatest volume of takeover activity in Europe, takeover disputes are resolved by a specialist panel which has a reputation for promptness and effectiveness.

It is appropriate to reconsider the function of the Australian Panel and, in particular, whether it is now desirable for it to fulfill the role envisaged for it.

Regulatory Framework

The Corporations Law currently provides two tiers of regulation of takeovers.

Firstly, takeover provisions enforced by the Federal and Supreme Courts require the bidder and target to provide full and accurate information to shareholders before the bidder acquires more than 20 per cent of voting shares. These provisions also prescribe time limits, formal requirements for takeovers and exceptions to the rules. Bidders, target companies, target shareholders and the ASC all have access to the courts to enforce these provisions.

A second tier of regulation is provided by the Panel.

The Panel

The Panel's current role is to intervene at the request of the ASC where parties to any acquisition of a 'substantial interest' in a company engage in conduct which may be strictly within the specific takeover provisions of the Corporations Law, but is not within the spirit of the Law. It may make a declaration and appropriate orders where it is satisfied that 'unacceptable circumstances' have occurred in relation to an acquisition of shares and that it is in the public interest to make the declaration. The matters which may amount to 'unacceptable circumstances' are set out in the Eggleston principles.[51]

Prior to 1991, the power to make declarations in relation to takeovers was vested in the then regulatory agency, the National Companies and Securities Commission. The Panel was established to avoid problems of the regulatory agency also playing an adjudicative role. Consistent with this, the ASC is the only person with standing to apply to the Panel.

The Panel is required to conduct its proceedings with as little formality and in as timely a manner as is consistent with the proper discharge of its functions.[52] It is not bound by the rules of evidence.[53] Regulations introduced on 1 January 1995 prescribe detailed procedures for the conduct of inquiries by the Panel, giving the parties short time frames to make their submissions.[54] This is intended to remove the uncertainty of the rules of natural justice which could otherwise be relied upon in legal challenges to the procedures adopted by the Panel.[55]

The Panel is currently funded as a part of the ASC's budget and the ASC provides staff and support facilities. The members of the Panel are appointed by the Governor-General on the recommendation of the Treasurer. There are currently 16 members of the Panel representing a range of expertise and experience, including directors, lawyers, accountants and securities advisers. Two members of the Administrative Appeals Tribunal and a retired judge are

51 Corporations Law, sections 732 and 733.

52 Australian Securities Commission Regulations, regulations 13 and 16(2)(c).

53 Australian Securities Commission Regulations, regulation 16(2)(a).

54 Australian Securities Commission Regulations, Part 3.

55 The rules of natural justice continue to apply to the extent that they are not excluded by the Regulations: *Australian Securities Commission Act 1989*, subsection 195(3). See also the Explanatory Memorandum to the Corporations Legislation Amendment Bill 1994, especially paragraph 282.

on the Panel to ensure that the Panel has the experience to hold inquiries in which parties are legally represented.[56] Three members of the Panel sit on each case.[57]

The Panel may in its discretion refer questions of law to the Federal or a Supreme Court rather than determine them itself.[58] Decisions of the Panel are not reviewable by the Administrative Appeals Tribunal.[59] However, they are reviewable under the *Administrative Decisions (Judicial Review) Act 1977*, under which the Federal Court may correct errors of law made by the Panel.

Only three matters have been referred to the Panel since its inception. The small number may reflect the fact that only the ASC has standing to make a referral. It would appear that the prospect of a referral often results in the correction of questionable takeover conduct, without the need for an actual referral. In its last two references, the Panel has shown itself able to make good use of its informal procedures to deliver a prompt decision.[60] There were some problems associated with the start-up phase of the Panel (in particular constitutional and other legal challenges),[61] but these appear to have been resolved.

Litigation Under the Current System

Applications for interim or final injunctions form the bulk of litigation.[62] Usually the target (or rival bidder) alleges that the bidder's Part A or Part C

56 Subsection 172(4) of the *Australian Securities Commission Act 1989* states: 'The Minister shall nominate a person as a member only if the Minister is satisfied that the person is qualified for appointment by virtue of his or her knowledge of, or experience in, one or more of the following fields, namely, business, the administration of companies, the financial markets, law, economics and accounting.' Note in this regard the survey and discussion in J Green, 'An Australian Takeover Panel — What do we want? A Panel Poll and Critique' (1989) 7 *Companies and Securities Law Journal*, at p 6.

57 *Australian Securities Commission Act 1989*, section 184.

58 *Australian Securities Commission Act 1989*, section 196.

59 See Corporations Law, section 1317B.

60 See *In the matter of Australian Securities Commission: Pivot Nutrition Pty Limited v Gibson's Limited* (unreported, 17 February 1997) and *In the matter of Australian Securities Commission and John Fairfax Holdings Ltd (ACN 008 663 161) shares* (unreported, 29 September 1997).

61 See *Precision Data Holdings Ltd v Wills* (1991) 173 CLR 167, known as the *Titan Hills case*.

62 See, for example, Corporations Law, sections 737 and 1324.

statement is misleading and then seeks an injunction to prevent the bid from proceeding as planned unless the statement is corrected.[63]

There is limited statistical data as to the extent of court actions over recent years, but anecdotal evidence suggests that litigation is frequent in hostile takeovers and is used for a mixture of genuine and tactical reasons. At the end of the intense takeover activity of the 1980s, it was found that the parties to a takeover, in particular the board of the target company, often engaged in litigation for tactical reasons.[64] This has apparently continued into the 1990s.[65]

Litigation may be especially attractive to a target or rival bidder if an interlocutory injunction can be obtained pending trial of the case. The courts will not always be able to hold a final hearing within the period of the bid, particularly if the issues raised are complex and likely to take up considerable court time.[66] Hence, the courts may have to decide between:

- disrupting the bid by granting an interlocutory injunction without the benefit of full evidence. The bidder will then need to determine whether it is viable to extend the period of the bid[67] and may need to issue a fresh Part A or Part C statement or seek approval (from the ASC or the court) for late service of the statement on shareholders;[68] or

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63 Most litigation concerns the requirement that Part A and Part C statements must include all information 'material to the making of a decision by an offeree whether or not to accept an offer, being information that is known to the offeror and has not previously been disclosed to the holders of shares in the target company': Corporations Law, section 750, Part A clause 17 and Part C clause 14.

64 See generally three articles by Tomasic and Pentony: 'Fast-tracking Takeover Litigation and Alternatives to Courts in Company Takeover Disputes' (1989) 17 *ABLR*, p 336, 'Litigation in Takeovers — The Decision-Making Process' (1990) 6 *Australian Bar Review*, p 67 and 'Resisting to the Last Shareholders' Dollar: Takeover Litigation — a Tactical Device' (1992) 1 *Aust Jnl of Corp Law*, p 154. The authors report on their survey of market participants, lawyers and judges. See also G F K Santow and G Williams, 'Taking the Legalism Out of Takeovers' (1997) 71 *Australian Law Journal*, p 749.

65 It is difficult to obtain accurate statistics on this issue. Many cases are apparently resolved at the interlocutory stage and remain unreported. Court data tends not to separate takeover cases from other commercial cases. Legal practitioners specialising in takeovers have advised that a substantial proportion of hostile bids involve litigation.

66 See *ICAL Ltd v County Natwest Securities Aust Ltd & Anor* (1988) 6 ACLC 467; 13 ACLR 129, *Solomon Pacific Resources NL v Acacia Resources Ltd* (1996) 19 ACSR 238 at 241-242, *Gantry Acquisition Corp v Parker & Parsley Petroleum Australia Pty Ltd* (1994) 51 FCR 554 and *Associated Dairies Ltd v Central Western Dairy Ltd* (1993) 44 FCR 335.

67 Underwriters and financiers may not be prepared to support the bidder over an extended period.

68 Note Corporations Law, sections 637, 679, 728, 730, 743 and 746(4). The ASC will generally extend the time for service of Part A or Part C statements barred by an

- allowing the bid to proceed even though it may later be found to be defective (at the risk of misleading shareholders).

If the bid is allowed to proceed and at the trial of the matter months down the track the court finds that the bidder contravened the takeover provisions, then the court will need to consider whether to unwind the takeover.[69] Where that is likely, the shareholders and management of the companies concerned will in the meantime be unsure who actually 'owns' the target company.

Certain court decisions have been criticised on the basis that they set the standards of disclosure at an unrealistically high level. At the same time, it is considered that the different approaches taken by different judges can encourage tactical litigation which might not be profitable before a tribunal applying a single standard.

Overseas Experience

There are several international precedents for the referral of takeover disputes to specialist bodies other than the courts. In particular, the Takeovers Panel which administers the non-statutory regulatory system in the United Kingdom has the reputation of resolving takeover disputes promptly and effectively.[70] Takeover disputes in Ontario may be taken to the courts or to the Ontario Securities Commission and the courts have consistently declined to re-open decisions of the Commission. More recently a statutory panel system has been established in Ireland.

More Efficient Dispute Resolution

Hostile takeovers by definition involve disputes between bidders and targets. Given the stakes, it is not surprising that the parties sometimes resort to litigation. The fact that litigation often results in findings that the bidder's disclosure has been inadequate suggests that a mechanism for dispute resolution is necessary to ensure that parties comply with the Corporations

interlocutory injunction, unless the bidder can get the injunction lifted by making appropriate disclosures: see ASC Practice Note 59, paragraph 73. Note also ASC Policy Statement 57, paragraphs 30-33.

69 See *Samic Ltd v Metals Exploration Ltd* (1993) 60 SASR 300.

70 A House of Lords Select Committee recently reported that the United Kingdom has an 'efficient and effective system for the regulation of takeovers' which they believed was 'an inspiration for others': House of Lords Select Committee on the European Communities, 13th Report, *Takeover Bids*, 9 July 1996, paragraphs 91 and 125.

Law. However, the apparent ready availability of litigation as a tactical defence also suggests that the courts are being used for tactical purposes unrelated to the underlying dispute.

It would be desirable for the disputes which will inevitably arise in connection with hostile bids to be resolved as quickly and efficiently as possible so that the outcome of the bid can be resolved by the target shareholders on the basis of its commercial merits. It is considered appropriate to vest this role in a specialist body largely comprised of experts in the field.

Consideration has been given to the establishment of a specialist court. However, this is not favoured because of the potential costs and the desirability of giving the dispute resolution forum a commercial rather than a legal focus.

Panel to have Primary Role

It is proposed that a reconstituted Panel will replace the courts as the principal forum for resolving takeover disputes under the Corporations Law, with the exception of civil claims after a takeover has occurred and criminal prosecutions. This would be achieved by enabling all interested parties to refer matters to the Panel and precluding the courts from granting an injunction which would have the effect of delaying or preventing a bid (other than on the application of the ASC). The Panel would enforce the spirit of the Law. In addition, the courts would have a discretion not to hear legal actions in the course of a takeover where they can be resolved effectively by the Panel.

The Panel would be expected to bring greater understanding and expertise to takeover disputes, particularly over time. Such a body would be well placed to act with speed in every case and to apply uniform standards, compared to the numerous Federal, State and Territory judges who of necessity operate largely independently from one another and with varying workloads and priorities.

Takeover disputes should ordinarily be resolved on a *final* basis within the period of the bid and with minimal disruption. The current system is unsatisfactory in that the potential exists to allow bids to proceed which might mislead the market or to stop bids which are not misleading simply because the courts may not have time to hear the matter fully within the period of the bid.

Under this proposal, the current restriction on standing to apply to the Panel would be lifted. All interested parties should have direct access to the Panel, given that it would be the principal forum for resolving takeover disputes. It would be unsatisfactory and inefficient for the ASC to be required to apply its resources to the preliminary investigation of takeover disputes, especially in times of high market activity. The time taken by the ASC to investigate would reduce the time available to the Panel to resolve the case within a reasonable period.

In light of the expanded role envisaged for the Panel, its jurisdiction would be reviewed to ensure that it is able to deal with any conduct which may involve the acquisition of shares in companies in a manner which is incompatible with the existence of an efficient, competitive and informed securities market. It is expected that the Eggleston principles would remain relevant in this regard, but it would be made clear that the Panel is able to deal with any conduct which amounts to a contravention of the spirit of the legislation where appropriate. This would include conduct involving the use of derivative instruments.[71]

The removal of the capacity of the court to grant injunctions other than on the application of the ASC will remove the major source of current tactical litigation. Parties would be able to challenge the efficacy of any conduct before the Panel on the basis of a contravention of the spirit of the Law. This more limited basis for disputation should largely avoid unmeritorious disputes on technical aspects of compliance with the provisions of the Law. Consistent with this, the Panel would be able to excuse technical breaches which may have been a source of litigation.

The Panel would administer the spirit of the Law through a power to make declarations of unacceptable conduct. Following such a declaration, the Panel would be able to make consequential orders. The legislation would make it clear that a declaration of unacceptable conduct may be made even where the conduct also involves a breach of the Law, but it need not do so merely because there has been a breach. As at present, there would be a requirement for any declaration of unacceptable conduct to be in the public interest.

It is proposed that the courts will retain their current jurisdiction to determine civil claims other than applications for injunctions, such as actions for damages. Claims of this kind are rare and the courts appear to be the appropriate forum for their determination.[72]

71 The decision of the Panel in *In the matter of Australian Securities Commission and John Fairfax Holdings Ltd (ACN 008 663 161) shares* (unreported, 29 September 1997) highlights potential difficulties with the jurisdiction of the Panel which will be addressed.

72 See especially Corporations Law, sections 613, 737, 739 and 744.

Litigation for damages is not attended by the same need for speed and informality as applies to applications to prevent acquisitions. By their nature, damages hearings are also likely to be lengthy and would potentially divert the Panel from other business. In light of the limited number of damages claims in relation to takeovers and the greater number of such claims in other commercial disputes, the courts are better qualified to assess damages. In order to avoid inefficiencies and benefit from any prior Panel proceedings, findings by the Panel in any earlier disputes would be *prima facie* evidence before the courts.

The CLERP paper on fundraising proposed that, consistent with proposed reforms for other securities transactions, section 52 of the *Trade Practices Act 1974* and equivalent sections of the State and Territory Fair Trading Acts prohibiting persons from engaging in misleading conduct will not apply to takeover documents.[73] Liability for misleading disclosure statements will be subject to appropriate defences reflecting the view[74] that, where the Law requires disclosure, those making the disclosure should have a defence if they have acted reasonably.

Making the Panel the primary forum for resolving takeover disputes would increase its role dramatically, necessitating a major increase in funding. This would come from full cost-recovery. A fee would be imposed for referring a matter to the Panel and hearing fees would also be payable by the parties. The funding of ongoing outlays would be contributed to by a levy upon the lodgment of takeover documents with the ASC. The Panel could also be empowered to award costs against parties appearing before it. The Panel's funding would be independent of the ASC.[75]

A full-time independent executive would be established to service the Panel and to deal with market participants on a day-to-day basis. The Panel would operate throughout Australia and hear matters in the State or Territory most appropriate for the particular case.

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73 *Fundraising*, Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 2, p 43.

74 See *Financial System Inquiry Final Report*, April 1997, pp 251-252 and Corporations Law Simplification Task Force, *Section 52 Trade Practices Act and Dealings in Securities*, September 1996.

75 Currently, the ASC's budget includes provision for the Panel and the ASC provides support to the Panel. This has been criticised: see G Williams, 'The Corporations and Securities Panel — What Future?' (1994) 12 *Companies and Securities Law Journal*, p 164 at 165-166.

The wider role envisaged for the Panel would necessitate some minor reforms to remove arbitrary time limits for Panel decisions and interim orders, whilst retaining the imperative that the Panel conduct its work expeditiously. In addition, the procedural rules relating to Panel proceedings contained in the Australian Securities Commission Regulations would need to be reviewed. This is particularly the case in light of recent experience, where the Panel referred to the legislative provisions as being excessively prescriptive and suggested that the Panel be conferred with greater powers to conduct inquiries without those inquiries becoming unduly legalistic.[76] It would be desirable to enable the Panel to conduct its proceedings as informally as is consistent with providing parties with a fair hearing and the expeditious resolution of the matter. Particular regard would be given to measures to avoid excessive legalism in proceedings.

In light of the expanded role for the Panel and the importance that it uphold and be seen to uphold the integrity of the market, Panel hearings would be public unless there is good reason for a particular hearing or part of a hearing to be held in private.

In order to provide appropriate protection against erroneous decisions and facilitate uniform standards, any aggrieved party would be able to appeal from decisions of the Panel to an appeal division of the Panel consisting of five members selected by the chairman of the Panel. However, to ensure that one type of litigation in court is not replaced with another, the scope for court review of decisions of the Panel would be restricted. The Panel would be given a wide jurisdiction and protected from judicial review whilst it operated in good faith and within reasonable bounds and complied with the procedures in the legislation and the rules of natural justice.

The courts currently have the role of enforcing Panel orders where there is a failure to comply, which is an offence.[77] It would appear that the current arrangements are adequate to ensure compliance with Panel orders.[78] In addition, it is arguably inappropriate for a non-judicial body which largely

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76 See *In the matter of Australian Securities Commission and John Fairfax Holdings Ltd (ACN 008 663 161) shares* (unreported, 29 September 1997), at pp 32-33, where the Panel suggested a number of reforms to improve the procedural rules governing Panel proceedings. For example, the Panel suggested that the parties should be the only persons to address the Panel (with legal advice available). A number of other issues raised by the Panel have been traversed in this paper.

77 Corporations Law, sections 734(5) and 736.

78 However, it should be noted that it has been suggested that, among other things, a further way of improving the standing of the Panel would be to give it the power to enforce its own orders: see G F K Santow and G Williams, ‘Taking the Legalism Out of Takeovers’ (1997) 71 *Australian Law Journal*, p 749 at 752.

consists of industry participants to be given the power to enforce its own orders.

It could be expected that the composition of the Panel would be reviewed if its role is expanded as proposed. In particular, a greater emphasis would be placed on including persons with direct expertise in takeovers, although there would continue to be a role for persons with wider commercial experience.

Constitutional Issues

The Australian Government Solicitor has advised that this proposal can be implemented in a constitutional manner. It involves a Territory administrative body exercising a mixture of State and Territory non-judicial power. Accordingly, limitations on the exercise of the judicial power of the Commonwealth do not apply.

Proposal No. 6 — Dispute Resolution

A reconstituted Panel should replace the courts as the primary forum for resolving takeover disputes under the Corporations Law, with the exception of civil claims after the takeover has occurred and criminal prosecutions. The Panel would enforce compliance with the spirit of the Law. All interested parties would be able to bring matters before the Panel, not just the ASC. Any aggrieved party would have a right of appeal from a Panel decision to an appeal division of the Panel. The courts would only be able to grant an injunction having the effect of delaying or stopping a bid on the application of the ASC. The capacity of the courts to review decisions of the Panel would be restricted.

PART 5: COMPETITION ISSUES

5.1 REGULATORY NEUTRALITY: MANAGED INVESTMENTS

The lack of statutory regulation of takeovers of managed investment schemes has been criticised, both on the basis that unit holders should have the same rights to share in a premium for control as shareholders and that scheme managers should face the same competitive pressure to perform as company directors.

Regulatory Framework

Currently, the takeover provisions do not apply to managed investment schemes, which are typically unit trusts. However, most listed schemes include in their trust deed takeover provisions based on the takeover provisions in the Corporations Law.

The inclusion of these provisions in trust deeds is not as effective as the application of the takeover provisions in the Corporations Law directly to managed investments. In particular, provisions contained in a trust deed will only bind a bidder once the bidder becomes a registered unit holder. Moreover, ASX Listing Rule 15.14 prohibits the manager, trustee or any other person from enforcing any takeover provisions contained in a listed scheme's trust deed.[79] Finally, the enforcement of trust deed provisions is primarily a matter for private action rather than the ASC.

79 The operation of ASX Listing Rule 15.14 is complicated by conflicting cases on the enforceability of takeover provisions contained in trust deeds: see *AF & ME Pty Limited v Aveling* (1994) 12 ACLC 831; 14 ACSR 499 and *West Merchant Bank Limited v Rural & Agricultural Management Limited & Ors* (1996) 14 ACLC 719; 20 ACSR 563.

Law Reform Proposals

In 1993, the Australian Law Reform Commission and CASAC recommended a review of the application of the takeover and compulsory acquisition provisions to managed investments. They also recommended requiring the disclosure of substantial holdings in listed schemes and a review of the application of disclosure obligations to unlisted schemes.[80]

In January 1996, the former Corporations Law Simplification Task Force recommended that, having regard to the purpose of takeover regulation and the relevant differences between companies and managed investments, takeover provisions should not apply to managed investments.[81]

In April 1997, the FSI recommended that takeover provisions should apply to public unit trusts.[82] The report indicated that Chapter 6 of the Corporations Law should be appropriately modified for takeovers of unit trusts, but did not consider in any detail the type of provisions that would be appropriate.

Overseas Experience

The company takeover rules in the United States, Canada, the United Kingdom and New Zealand do not apply to takeovers of non-corporate managed investment schemes. However, where such schemes take a corporate form (which is typically the case with North American mutual funds), these rules apply in the same way as they do to other companies. Nonetheless, hostile takeover activity in relation to managed investments is rare.

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80 Australian Law Reform Commission and the Companies and Securities Advisory Committee, *Collective Investments: Other Peoples Money*, Volume 1 at paragraphs 11.10-11.12 and 11.29-11.31.

81 See *Takeovers: Proposal for simplification*, Simplification Task Force, January 1996, proposal 27, issue for consideration 27(B) and pp 20-21. The Task Force instead recommended a more limited measure of refining the voting rules so that a scheme's manager could be replaced by an absolute majority of disinterested members. The existing manager, the proposed new manager and their associates would be excluded from voting.

82 *Financial System Inquiry Final Report*, April 1997, Recommendation 87. It would appear that 'public unit trusts' refers to unit trusts which are offered to the public whether or not the units are listed on a stock exchange. These would not include, for example, employee sponsored superannuation funds which are not offered to the public at large: p 480.

Applying Takeover Rules to Managed Investments

Entities which perform substantially the same role should *prima facie* be subject to similar regulation. This will enhance regulatory neutrality and increase market efficiency.[83] At one level public companies and managed investment schemes perform different functions. The vast bulk of major public companies are vehicles for business enterprises, while managed investment schemes are usually vehicles for the pooling of funds for passive investment activities. However, the reverse is also true for many companies and schemes. It appears anomalous that the acquisition of shares in a listed investment company is subject to the takeover provisions but the acquisition of units in a listed scheme, which performs substantially the same activities, is not.

This is all the more apparent given that from an investor's perspective there is little difference between holding units in a scheme or shares in a company. Although a unit is legally very different from a share, the rights attached to units often approximate the rights attached to shares. Both unit holders and shareholders have the power to amend their trust deeds[84] or articles of association respectively. Unit holders are often in a similar commercial position to shareholders with respect to returns on their investment.

In addition, the management of a scheme is usually conducted by the manager in a fashion which is closely analogous to the management of a company by its directors. The manager and trustee[85] usually owes fiduciary duties to the unit holders under the scheme's trust deed, which are similar to the duties owed by company directors to the company.[86]

It follows that, in the absence of compelling practical or policy reasons to the contrary, the company takeover rules should apply to managed investments.

83 Australian Law Reform Commission and the Companies and Securities Advisory Committee, *Collective Investments: Other Peoples Money*, Volume 1 at paragraph 2.24.

84 Under proposed new arrangements for regulating managed investments announced by the Government on 24 August 1997, schemes will be required to have a constitution, in place of the current requirement to have a trust deed. Unit holders will continue to have the power to amend the scheme's constitution.

85 The proposed new arrangements for regulating managed investments will require a single responsible entity, in place of the current trustee and manager. This will resolve the current confusion and lack of accountability which arises from the division of duties between the manager and the trustee.

86 G Green and A Dhar, 'Takeovers of Public Unit Trusts' (1991) 19 *Australian Business Law Review*, p 19 at 21 and D Brewster, 'Fiduciary Obligation of Trust Managers and the Takeover of Unit Trusts' (1990) *Companies and Securities Law Journal*, p 303 at 305.

Practical Considerations

One of the practical problems with applying takeover rules to managed investments is that a scheme can be 'taken over' not only by acquiring sufficient units to call a meeting of unit holders and vote for the winding up of the scheme or replacement of the manager, but also by obtaining control over the management rights of the scheme (either by purchasing them directly from the manager or by obtaining a controlling interest in the manager). The company takeover provisions are not readily applicable to regulating changes of control by obtaining control of management rights.

Another practical aspect of takeovers of managed investments relates to the incentive for a bidder to reach a high level of control. In company takeovers, the bidder will often seek to gain 100 per cent control of the target. For managed investment schemes, the prime motivation for a takeover may be to access the management fees from the scheme's income stream. However, if a bidder for a scheme intends to install itself or an associate as the manager, acquisition of up to 100 per cent of the units would result in the bidder effectively paying itself the management fees. There may be an incentive for the bidder to do this if a scheme has special qualities, such as investment in a unique asset, or the bidder intends to resell the units after it has replaced the manager.

Takeover by Purchasing Units

For listed managed investment schemes, where the redemption facility is suspended,[87] units trade at a price set by the market. Historically, listed units trade on-market at a discount to their net asset backing reflecting the illiquidity of the underlying assets. This provides an opportunity and incentive for a bidder to pay a premium over the market price for control parcels of undervalued units.

However, this is not the case with most unlisted schemes where the manager provides investors with a withdrawal facility at a price reflecting the net asset backing of the units.[88] Thus, there would be no commercial incentive for a bidder to pay a premium over the redemption price and wind up the scheme, as the bidder is unlikely to be able to obtain the underlying assets at a

87 ASX Listing Rule 1.1 condition 5.

88 A buy-back covenant is required to be included in a scheme's trust deed: Corporations Law, paragraph 1069(1)(d). The obligation under this covenant is often discharged through units being redeemed from scheme assets.

discount to make a profit on winding up. It will also provide a strong disincentive for a bidder seeking to replace the manager if the bidder must pay a premium for the units above the value for which they can be redeemed.

Other operating features of many unlisted schemes make the application of company takeover rules impractical. In particular, in the case of 'open-ended' schemes, new interests are issued on a continuous basis as investments are made. While the potential effect of this could be overcome by the imposition of 'freezes' on the issue of new interests when a takeover bid is launched, this would appear to amount to an unwarranted interference in the ordinary operation of the scheme.

Proposal No. 7 — Takeovers of Listed Managed Investment Schemes

The takeover provisions of the Corporations Law, including the provisions on compulsory acquisitions and disclosure of substantial holdings, should apply to listed managed investment schemes subject to appropriate modifications. This would override any inconsistent takeover rules contained in the ASX Listing Rules or existing trust deeds.

Removal of the Manager

One issue that arises from the application of the takeover provisions to managed investment schemes is what should be the statutory rule for the replacement of the scheme manager. At present, the relevant statutory rule requires a vote by 50 per cent by value of unit holders to remove the manager.[89] In contrast, the ASX Listing Rules require a listed scheme's trust deed to allow removal of the scheme's manager by an ordinary resolution of unit holders.[90] The listing rule approach is consistent with the rule for the removal of company directors.

It is sometimes argued that the higher statutory threshold should be retained for managed investment schemes as the manager of a scheme will often invest a significant amount of intellectual and financial capital in personnel and systems to manage the scheme. In the takeover context, the consequences of replacing a manager can be far more disruptive than replacing a board of directors, as the hostile change of a manager may involve changing most or all

89 Corporations Regulations, regulation 7.12.15(10)(g).
90 ASX Listing Rule 13.3.

of the scheme's infrastructure. If investors removed a director, or even the board of directors, of a listed company it is less likely that all employees, management staff and corporate systems would change.

As a result, it is often argued that the law should protect the manager by imposing high voting thresholds for removing the manager. This 'entrenchment' of the manager is said to be justified to protect it from 'predatory' players who would seek to acquire the management rights for a scheme. It is argued that, without some form of entrenchment, managers would be discouraged from committing significant capital to new schemes if their investment could be captured by a predatory bidder. This argument is usually aligned with an argument that many investors invest in a scheme on the basis of the manager's investment skills or past performance.

Whilst these arguments have some merit, the countervailing consideration is that managers should not be unduly entrenched by the law. To do so would remove competitive pressures from the managed investment industry. In addition, the argument that entrenchment is necessary to protect scheme managers who commit significant capital to new schemes appears unfounded. An examination of recent prospectuses of schemes listing on the ASX suggests that most scheme managers recover establishment costs immediately from the funds raised.

Given that it is argued that unit holders are generally passive investors, due to the indirect nature of their investment, 50 per cent represents a relatively high voting threshold. Bringing the statutory voting rules into line with those in the ASX Listing Rules and for company directors would reinforce the greater accountability sought to be imposed under the ASX Listing Rules and avoid any suggestion of entrenchment of the manager if the takeover rules were to provide a disincentive to a change in manager.

Another problem with the current voting rules is that they enable the bidder and its associates to vote on the removal of the manager, while the existing manager and its associates are excluded from voting.[91] It is argued that this disenfranchises those investors who have already indicated a preference in favour of the existing manager by purchasing units in the scheme. Where the manager and its associates hold a large percentage of the units, the manager could be removed by a vote of just half of the value of the minority unit holders.

91 Corporations Regulations, regulations 7.12.15(6)(f) and (9)(b)(i).

One approach to amending the statutory voting rules would be to also exclude a bidder and its associates from voting on a change of manager.[92] This would make it more difficult for a bidder to replace the existing manager. However, a consequence of this approach would be the possible entrenchment of underperforming managers.

The better approach, which would avoid the risk of entrenching existing managers, would be to change the existing statutory voting rules so that managers can be replaced on the same basis as company directors. Company directors can be replaced by a simple majority at a general meeting of shareholders, without any restrictions on who can vote.

Proposal No. 8 — Removing Listed Scheme Managers

To be consistent with the ASX Listing Rules, the legislation should make it clear that the manager of a listed managed investment scheme is able to be replaced on the same basis as company directors, namely by a simple majority of unit holders who vote at a duly convened meeting (whether in person or by proxy).

Takeover by Purchasing Management Rights

A person can also take over a scheme by taking over the manager or by purchasing the management rights to the scheme. Where the bidder takes over the manager, the takeover provisions may apply to protect shareholders of the manager. However, the provisions will not operate to give unit holders any involvement in the takeover process.

In both cases, any premium for control of the management rights to the scheme passes to the existing manager without any benefit accruing to unit holders. It is arguable that this does not affect the 'control premium' for the scheme itself, which is retained by the unit holders who at all times have the capacity to call a meeting and vote to remove the manager. Nevertheless, a change in control of the management rights may affect the value of the units.

The main issue is the extent to which unit holders should have a 'right of veto' over changes in the manager under these circumstances. Under the current law, the assignment of the management rights to a scheme is not required to

92 *Takeovers: Proposal for simplification*, Simplification Task Force, January 1996, proposal 27 and p 21.

be approved by a meeting of unit holders. This can be compared to changes in the management of a company. Where a director of a company assigns their office to another person, the assignment is ineffective until approved by a special resolution of shareholders.[93] Where the directors of a company appoint a director, either to fill a casual vacancy or as an additional director, it is usual for the constitution of the company to provide that the director's appointment must be approved by the next annual general meeting of the company.[94] Consistent with this, it is proposed that changes in control of listed managed investment schemes be subject to unit holder approval.

Proposal No. 9 — Other Changes of Control of Listed Managed Investment Schemes

Changes in control of listed managed investment schemes by acquisition of the manager of the scheme or by acquisition of the management rights for the scheme should be approved by a simple majority at a unit holders' meeting.

5.2 Regulatory Neutrality: Schemes of Arrangement

Although schemes of arrangement are used in cases of company insolvency, they can also be used to effect a change of corporate control similar to a takeover. The following discussion examines the interface between the takeover provisions and the scheme provisions in Part 5.1 of the Corporations Law. It does not preclude nor pre-empt any review of the general operation of the scheme provisions.[95]

The main issue for consideration is whether the Law should allow schemes to operate as a regulatory alternative for some takeovers.

93 Corporations Law, subsection 238(1).

94 See, for example, the model rules contained in the Corporations Law, Schedule 1, Table A, regulation 61.

95 For simplicity, the generic term 'scheme' has been used in place of the various descriptions in the Corporations Law of scheme, compromise and arrangement.

Regulatory Framework

In a scheme which has the effect of a takeover, control of the 'target' company is transferred to the 'bidder' company by cancelling all of the shares in the target other than those held by the bidder. Shares in the bidder are then issued to the former shareholders of the target as compensation for cancellation of their shares.

The scheme provisions require the company to apply to the Court to convene meetings of affected creditors and members. Both the Court and the ASC have an opportunity to consider the explanatory material that must accompany the notices of meetings.[96] The explanatory material includes information that is similar to information that must be disclosed for a takeover offer. At the meetings, the scheme must be approved by each class of affected creditors and members by a majority of at least 75 per cent in value of their interest. A further application must then be made to the Court for approval of the scheme.[97] In addition, the ASC must be notified and given an opportunity to make submissions to the Court.[98]

Historically, the courts have approved schemes which had the effect of a takeover.[99] In 1982, a provision was introduced which prevents a court from approving a scheme unless:

- it is satisfied that the scheme is not proposed for the purpose of avoiding the takeover provisions; or
- the ASC states that it has no objection to the scheme.[100]

However, a number of cases which have considered this provision have approved schemes despite ASC submissions opposing the schemes. The effect of these cases is that schemes continue to be available to achieve a takeover provided an essential element of the scheme could not be achieved under the

96 Corporations Law, subsections 411(1) and (2).

97 Corporations Law, subsection 411(4). Although a court must be satisfied that the scheme is reasonable, once a majority of members and creditors have approved the scheme, courts are reluctant to find it unreasonable: see *Re Stockbridge Ltd* (1993) 9 ACSR 637; 11 ACLC 201 at 210.

98 Corporations Law, subsection 411(2).

99 See, for example, *Re Bank of Adelaide* (1979) 22 SASR 481 and *Re Wallace Dairy Co Ltd* [1980] VR 588.

100 Corporations Law, subsection 411(17).

takeover provisions, such as the cancellation of renounceable options or the reduction of capital.[101]

Benefits of Allowing Schemes as an Alternative to Takeovers

Allowing schemes to operate as an alternative to takeovers gives business the flexibility to access commercial advantages available under a scheme which are not available under a takeover. Schemes may also facilitate the efficient allocation of capital by enabling the reorganisation of companies in ways which are not possible under ordinary commercial arrangements.

The advantages of schemes under the current law include:

- a lower level of target shareholder assent, however this will depend upon the bidder's initial shareholding in the target. Under a scheme, the bidder can acquire 100 per cent of the shares of the target company, if agreed to by a majority of at least 75 per cent in value of the target's shares.[102] Dissenting members and creditors are bound by the scheme. Under a takeover bid, the bidder can only get to 100 per cent if the offer is accepted by 75 per cent in number of the target shareholders and the bidder holds 90 per cent of the target's shares enabling it to use the compulsory acquisition procedure. However, this 'commercial advantage' is a disadvantage when viewed from the standpoint of investors because of the possible lower level of shareholder assent required;
- the courts' power to make ancillary orders, often binding third parties, to facilitate implementation of the scheme. For example, a court order can transfer contracts and liabilities that cannot ordinarily be transferred;
- the ability to collapse a number of steps involved in the takeover and subsequent reconstruction of the company;
- the possibility of using merger accounting and thus avoiding the identification of goodwill; and
- the ability to acquire more than one class of share or security.

101 See *Re ACM Gold Ltd; Re Mt Leyshon Gold Mines Ltd* (1992) 34 FCR 530 and *Re Stockbridge Ltd* (1993) 9 ACSR 637; 11 ACLC 201. See also *Re Advance Bank Australia Ltd* (1997) 22 ACSR 513; 15 ACLC 248.

102 Gaining 100 per cent control is an important consideration for transferring group tax losses: *Income Tax Assessment Act 1936*, section 80A (see Part 4.2).

However, it has also been argued that schemes are cumbersome, slow and costly,[103] and may have less flexibility than takeover bids. For example, variations of a scheme require further court approval or even recommencement of the entire approval process. Thus it is extremely difficult for a bidder to increase the price offered under a scheme and this may have 'devastating' consequences if a rival bidder offers a higher price.[104]

Costs of Allowing Schemes as an Alternative to Takeovers

The main cost is that market participants may engage in 'regulatory arbitrage', that is, avoid the takeover provisions by using the scheme provisions. If the takeover provisions contain additional requirements justified on economic and regulatory policy grounds, regulatory arbitrage may subvert these economic and policy objectives.

The Eggleston principles underlying the takeover provisions are designed to ensure that shareholders have sufficient time and information and an equal opportunity to participate in changes in corporate control. Both the courts and the ASC take these principles into account when approving schemes.[105] The involvement of the courts and the ASC thus ensures that there is adequate shareholder protection.

Regulatory arbitrage may also distort the behaviour of market participants, encouraging them to engage in commercial behaviour the only purpose of which is to bring them within a particular regulatory regime. This type of behaviour can be seen as economically inefficient.

In practice, schemes will only be a viable alternative to takeovers in a limited number of situations. For example, schemes would not be a viable alternative to a hostile or defended takeover bid, as it is the target company which must bring the scheme before a court for approval. This will form a 'natural' hurdle to using schemes as an alternative to takeovers. In addition, the courts have clearly indicated that they will only approve a scheme which has the effect of a

103 Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45, AGPS, 1988 at paragraph 46.

104 See R Levy, *Takeovers Law and Strategy*, LBC Information Services, 1996 at p 35.

105 The courts will consider the requirements of the takeover provisions when approving a scheme that has the effect of a takeover: see *Re Archaean Gold NL* (1997) 15 ACLC 382. The ASC also considers takeover principles and disclosure requirements when considering these schemes: see ASC Policy Statement 60, *Schemes of arrangement ¾ s411(17)*, 15 July 1993 and draft Policy Statement, *Schemes of Arrangement and ASC Review*, 8 October 1997.

takeover where an essential element of the scheme could not be achieved by a takeover.

Proposal No. 10 — Schemes of Arrangement

The current approach to takeovers by scheme of arrangement should be retained. This would continue to allow schemes to be used to transfer control of a 'target' company to a 'bidder' company (by cancelling all of the shares in the target other than those held by the bidder), subject to the operation of the scheme provisions.

5.3 Competitive Neutrality: Governmental Immunity

Although takeover activity by the Federal, State or Territory Governments and their agencies is infrequent, their capacity to acquire substantial interests in companies without complying with the takeover laws has from time-to-time been criticised.

Regulatory Framework

The doctrine of Governmental immunity relates to certain immunities and privileges which apply to governments at common law, including the Government not being bound by legislation in the absence of a clear Parliamentary intention. The Commonwealth, States and Territories are currently exempt from the operation of the takeover provisions.[106] This immunity generally extends to agents and private parties engaged by government to carry out the relevant transaction.[107]

106 The takeover provisions do not apply to an acquisition of shares in a target company which is an instrumentality or agency of the Crown: Corporations Law, subsection 633(b) and Corporations Regulations, regulation 6.2.01(a). Nor do the provisions apply to the Crown in the capacity of a purchaser of shares or a takeover bidder: *Corporations Act 1989* (Cth), section 17; *Corporations ([Name of State]) Act 1990* (of the States and the Northern Territory), sections 15 and 16.

107 See *Bradken Consolidated Limited v The Broken Hill Proprietary Company Limited* (1979) 145 CLR 107 and *Woodlands v Permanent Trustee* (1996) 68 FCR 213.

Competitive Neutrality

The operation of Governmental immunity in the companies and securities field generally was criticised by the Senate Standing Committee on Legal and Constitutional Affairs in 1992. The Committee concluded that where government business enterprises engage in purely commercial activities and compete with private enterprises, it may be desirable to eliminate the immunity altogether.[108]

Governmental immunity from the takeover provisions is also inconsistent with the principles of competitive neutrality agreed by the Commonwealth, State and Territory Governments, arising out of the report on National Competition Policy.[109]

It has been proposed in the context of CLERP that governmental immunity be removed in relation to the fundraising provisions.

Benefits of Removing Governmental Immunity

Exempting government business enterprises from the takeover provisions gives them an unfair advantage in the marketplace, inconsistent with the principle of competitive neutrality. The most significant benefit of removing Governmental immunity from the takeover provisions would be to improve competitive neutrality between government business enterprises and private sector business.

Competitive neutrality will remove resource allocation distortions and improve competitive processes. Resource allocation distortions occur because prices charged by government businesses need not fully reflect resource costs. This can distort investment and other decisions of private sector competitors. Competitive neutrality is part of broader economic policies aimed at increasing reliance on market based mechanisms and competition to promote efficiency and competitiveness.

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108 *The Doctrine of the Shield of the Crown*, Report by the Senate Standing Committee on Legal and Constitutional Affairs, December 1992, paragraph 9.9.

109 *National Competition Policy*, Report by the Independent Committee of Inquiry (Hilmer report), August 1993, p 293. As a result, in June 1996, the Commonwealth released its Competitive Neutrality Policy Statement, which states that 'the Commonwealth's competitive neutrality arrangements will directly address . . . exemptions from complying with regulatory arrangements imposed on private sector competitors': p 6.

Costs of Removing Governmental Immunity

The principal cost of removing Governmental immunity from the takeover provisions is the increase in compliance costs for government, their business enterprises and instrumentalities. For example, the takeover provisions would apply where a government made a takeover bid for a private sector body. However, it would be rare that a government would take such an action. The takeover provisions would primarily apply to government business enterprises which have already been corporatised and partially privatised.

The removal of Governmental immunity will also affect government business enterprises used to provide community services. However, it should be recognised that it would be highly unusual for a government business enterprise to engage in takeover activities.

Removing Governmental Immunity

The benefits of removing Governmental immunity outweigh the costs. Accordingly, the Commonwealth, States and Territories should no longer be immune from the takeover provisions.

Removal of the immunity of the States and the Northern Territory would require the agreement of the relevant Governments and Parliaments. Whether or not this agreement is obtained, the immunity of the Commonwealth should be removed.

Proposal No. 11 — Governmental Immunity

The Federal, State and Territory Governments and their business enterprises should be subject to the takeover provisions.

Appendix A: Business Regulation Advisory Group

Mrs Catherine Walter	(Chairman) Australian Institute of Company Directors
Mr Peter Barnett	Business Council of Australia
Mr Leigh Hall	Australian Investment Managers' Association
Mr Rohan Jeffs	Australian Chamber of Commerce and Industry
Mr Jeffrey Lucy	Accounting bodies
Mr John Murray	Small Business Coalition
Mr Robert Nottle	Australian Stock Exchange
Mr Malcolm Starr	Sydney Futures Exchange
Mr Les Taylor	Australian Corporate Lawyers Association