NATIONAL COMPANIES AND SECURITIES COMMISSION

DEFENSIVE SCHEMES AND THE DUTIES OF DIRECTORS

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A discussion paper submitted to the Ministerial Council for Companies and Securities on 26 September 1986.

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SUMMARY AND CONCLUSIONS

1. At its meeting in July 1986, the Ministerial Council expressed concern that directors of companies involved with defensive schemes may not be acting in the best interests of their shareholders. It directed the Commission to prepare a report for its next meeting. This is that report.

2. The report:

(i) defines defensive conduct;

(ii) sets out present law and Commission policy in relation to directors' duties;

(iii) discusses important issues relating to motives of directors, detriment to shareholders and whether defensive schemes are effective over time;

(iv) examines, in the light of a survey undertaken by the Commission, a range of tactics used when a bid is made or may be imminent;

(v) discusses, in the light of a report by a consultant merchant banker, strategies designed to ensure that a bid is never Fade.

3. It reaches the following conclusions:

(i) tactical and strategic measures which have defensive implications are common;

(ii) it is very difficult to determine whether defensive motives predominate when directors decide to introduce these measures;

(iii) although the majority of bids are not defended there has been a marked increase in the propensity to defend in the 1980's;

(iv) there has been little change in the incidence of most defensive tactics. In seven out of ten categories the survey results for 1984 and 1985 are within five percent of the survey for 1970-79. The major exceptions are an increased tendency by target companies to appeal to regulators and to litigate and a decreased tendency to enter into agreed takeovers and to increase dividends.

(v) in the majority of cases where defensive tactics are employed, the offeror increases the offer price;

(vi) defensive tactics tend to have a high rate of success in defeating bids initially, but subsequent agreed takeovers and hostile bids which are successful mean that, over time, defensive tactics generally do not succeed in preserving the position of directors (assuming that this was the intention).

4. Because of the complexity of the issue and the present shortage of data in relation to defensive schemes the conclusions cannot be considered as final.

5. The Commission would welcome comments on any of the issues raised in these papers by 31 December 1986.

DEFENSIVE SCHEMES

AND THE DUTIES OF DIRECTORS

1. At its meeting in July 1986 the Ministerial Council considered a report from the Commission about its investigation into the so-called "Australia 2000" Club. Ministers:

(i) expressed concern that directors of companies involved with defensive schemes may not be acting in the interests of their shareholders; and

(ii) directed the NCSC to look further into this matter and to make a report to the next meeting of the Ministerial Council with a view to considering if that report should be released publicly.

Methodology

2. The Commission has considered a wide range of schemes which are often said to be "defensive", the duties of directors who contemplate entering into, or setting up, such schemes and the effect of those schemes on shareholders. This is a wide-ranging task and Australian research on the subject is scanty. The Commission therefore decided to deal with defensive tactics by gathering data about the incidence and results of tactics adopted in the face of an actual or intending bid. The problem of defensive strategies adopted to prevent a bid being made in the first place was more complex. There was not enough time to assemble the long-term data needed for a detailed study of defensive strategies and they are also undergoing considerable change. For this reason the Commission appointed a consultant, Mr. Robert Johanson of Macquarie Bank Limited, to give it first-hand advice about current practices and their impact. Mr. Johanson's study, which reflects the broad brief the Commission gave him, is Attachment One. It has not been edited. The differences between the Commission's paper and Mr. Johanson's are largely due to the Commission's decision to approach the subject from the viewpoint of investor confidence. The Commission's conclusions in relation to defensive strategies are therefore less emphatic.

Definitions

3. There is no general agreement about what constitutes defensive action in the context of a takeover. It is sometimes used very widely to refer to conduct by directors which is intended to force a hostile bidder to offer a better price as well as to deter or defeat a takeover. More narrowly, it refers only to actions taken by directors which are intended to advantage them at the expense of their shareholders. Whether defensive actions are consistent

with desirable duties depends greatly on the scope of the definition.

4. On the wider view directors faced with the threat of takeover should use their powers to foster an auction or to ensure that any offer is made at a price which fully represents the value of the shares in the company and is at the best price which can be obtained. Such action is of positive benefit to shareholders. The same cannot be said where directors use their power to build protective fences round the company and prevent the free operation of the market for control of the company with the object of entrenching themselves at the expense of those to whom they have a fiduciary duty.

5. The Commission takes a wide view of what constitutes defensive action in response to the possibility of a takeover. It recognises that some action commonly considered to be defensive is desirable and endorses the view that directors are under a duty to facilitate an auction for the company and to maximize the price at which an offer is made. However it cannot condone action designed to prevent or thwart a takeover bid without reference to the interests of all shareholders. Directors are servants of the owners of the company and should not act in a manner interned to remove from shareholders the opportunity to consider an offer for their shares. Shareholders have the right to decide whether incumbent directors and managers should continue in office and directors should not use their powers to pre-empt the possibility that a takeover will be the means of implementing a change of management.

6. This paper focuses on defensive conduct which may damage the interests of shareholders and investor confidence. Specifically it considers whether directors who enter into schemes which may deter or defeat takeovers do so in breach of their duty to shareholders. The conclusions are not final, firstly because the Commission is aware that there is still considerable debate on the subject (to which this paper is intended to contribute) and secondly because of the dearth of research and data on the topic.

Directors' Duties

7. The general duties of directors are found in the common law and in section 229 of the Companies Act and Codes. The Commission, in its Policy Release 403, has also expressed its opinion about the duties of directors in a takeover situation. The legislation which governs the procedure of takeovers, the Companies (Acquisition of Shares) Act and Codes ("CASA") also prescribes or proscribes particular conduct on the part of directors.

8. The general principle to be applied is that directors must act "bona fide and for the benefit of the Company as a whole" Allan v. Gold Reefs of West Africa [1900] 1 Ch. 656 at 671. This legal and equitable duty of directors requires a substantial elaboration

before the general principle can be applied to particular facts. In the words of a leading text book,

" ..... the fact that directors are fiduciaries imposes on them (1) subjective duties of honesty and good faith, and (2) objective duties not to place themselves in a position where their duties might conflict with their private interests. In practice,

however, each of these can be sub-divided resulting in four facets of the general principle which are probably best treated as distinct, though in practice they tend to overlap. First, the directors must act bona fide, that is in what they believe to be the best interests of the company. Secondly, they must exercise their powers for the particular purpose for which they were conferred and not for some extraneous purpose, even though they honestly believe that to be in the best interests of the company. Thirdly, they must not fetter their discretion to exercise their powers from time to time in accordance with the foregoing rules. And finally, despite compliance with the foregoing rules, they' must not, without the consent of the company, place themselves in a position in which there is conflict between their duties and their personal interests.

In most cases compliance with the rule that directors must act honestly and in good faith is tested on common sense principles, the court asking itself whether it is proved that the directors have not done what they honestly believed to be right, and normally accepting that they have unless satisfied that they have not behaved as honest men of business might be expected to act. However, directors are required to act "bona fide in what they consider - not what a court may consider - is in the interests of the company and not for any collateral purpose." Hence there Fay be a breach of duty, notwithstanding that it is not shown that they have acted with any conscious dishonesty, if they have acted as they did because it was in their own interests or that of some third party, without considering whether it was also in the interests of the company". [L.C.B., Gower, Principles of Modern Company Law, 4th ed., 576-577.]

9. Section 229(1) of the Companies Code provides:

"An officer of a corporation shall at all times act honestly in the exercise of his powers and the discharge of the duties of his office."

10. It does not appear that the interpretation of this sub-section requires any departure from the meaning given to directors duties in civil cases. In Marchesi v. Barnes [1970] V.R. 434 Gowans J considered the predecessor to section 229(1) (section 124(1) of the (Companies Act 1961) and said:

"Involved in all this is the conception of "acting honestly in the discharge of the duties of the office of a director". The Full Court in Byrne v. Baker, [1964] V.R. 443 has attributed the source of the language used in section 124(1) (formerly section 107(1) to the judgment of Romer, J., in Re City Equitable Fire Insurance Co. Ltd., [1925] 1 Ch.407; [1924] All E.R.Reg. 485, a judgment which

in turn refers to the language of Lindley, M.R., in Laqunas Nitrate Co. v. Laqunas Syndicate, [1899] 2 Ch.392, at p.435; [1895-9] All E.R. Rep. Ext.1349: "act honestly for the benefit of the company they represent". This is the language it has become customary to use in respect of a director's duty in the exercise of his powers or position. "They must exercise

their discretion bona fide in what they consider - not what a Court may consider - is in the interests of the company, and not for a collateral purpose" (per Lord Green, M.R., in Smith v. Fawcett, [1942] 1 Ch.304, at p.306). The company in this passage means the company as a whole. This background to the language of the section appears to justify the conclusions, first, that the section is not concerned with the conduct of a director in relation to creditors or other persons dealing with or concerned with the company or anybody else but the company itself; secondly, that it is concerned with the performance of his fiduciary duty to the company; and, thirdly, that to "act honestly" refers to acting bona fide in the interests of the company in the performance of the functions attaching to the office of the director. A breach of the obligation to act bona fide in the interests of the company involves a consciousness that what is being done is not in the interests of the company, and deliberate conduct in disregard of that knowledge. This constitutes the element of mens rea in the criminal offence created by that statute. If the term "fraud" is applicable in this situation, it is only so in the sense of a "fraud on the power". In effect, the common law obligation to act with due diligence has been made a statutory duty, and failure to perform it, provided there is the proper mental element, has been Fade a criminal offence." at pp 437-438.

11. The judgment of Dixon J. in Mills v. Mills (1938) 60 CLR at 185-186 is also relevant. His Honour said:

"Directors of a company are fiduciary agents, and a power conferred upon them cannot be exercised in order to obtain some private advantage or for any purpose foreign to the power. It is only one application of the general doctrine expressed by Lord Northington in Aleyn v. Belchier (1) (1758) 1 Eden 132, at p.138, 28 E.R. 634, at p.637: 'No point is better established than that, a person having a power, must execute it bona fide for the end designed, otherwise it is corrupt and void.'

Upon the facts of the present case, or at all events upon the expressions used by Lowe J. in stating his findings, it may be thought that a question arises whether there must be an entire exclusion of all reasons, motives or aims on the part of the directors, and all of them, which are not relevant to the purpose of a particular power. When the law Fakes the object, view or purpose of a man, or of a body of men, the test of validity of their acts, it necessarily opens up the possibility of an almost infinite analysis of the fears and desires, proximate and remote, which, in truth, form the compound motives usually animating human conduct. But logically possible as such an analysis may seem, it would be impracticable to adopt it as a means of determining the validity of the resolutions arrived at by a body of directors,

resolutions which otherwise are ostensibly within their powers. The application of the general equitable principle to the acts of the directors managing the affairs of a company cannot be as nice as it is in the case of a trustee exercising a special power of appointment. It must, as it seems to me, take

the substantial object the accomplishment of which formed the real ground of the board's action. If this is within the scope of the power, then the power has been validly exercised. But if, except for some ulterior and illegitimate object, the power would not have been exercised, that which has been attempted as an ostensible exercise of the power will be void, notwithstanding that the directors may incidentally bring about a result which is within the purpose of the power and which they consider desirable."

12. In Howard Smith Ltd. v. Ampol Petroleum Ltd. (1974) AC 821 the Privy Council approved the test formulated in Mills v. Mills, supra, and on the facts before it, held that the primary purpose of the directors of Millers in allotting the shares in question to Howard Smith was not to satisfy Miller's need for capital, but to destroy the majority holding of Ampol and Bulkships. Their Lordships accordingly upheld the judgment of Street J. setting aside the allotment of shares and ordering rectification of the Millers share register.

13. In Release 403, the Commission, after citing the views of Lord Wilberforce in the Howard Smith case referred to above, adds:

"In this context, a provision of the London City Code is also relevant:

"At no time after a bona fide offer has been communicated to the board of an offeree company or after the board of an offeree company has reason to believe that a bona fide offer might be imminent shall any action be taken by the board of the offeree company in relation to the affairs of the company, without the approval in general meeting of the shareholders of the offeree company, which could effectively result in any bona fide offer being frustrated or in the shareholders of the offeree company being denied an opportunity to decide on its merits".

No two takeover situations are alike and the formulation of all-encompassing rules for this matter is impracticable. Solely by way of illustration, however, a defensive tactic which has been canvassed with the Commission is whether the directors of a target company whose members have received takeover offers are entitled to make a counter bid for shares of the offeror company. In general, the Commission would deprecate such a defensive tactic unless the counter bid is made with the approval in general meeting of the members of the target company. Indeed, if unrestrained, such tactics would merely result in two companies competing in a race for control against each other."

14. In relation to specific actions, CASA imposes both positive and negative duties. Section 50 limits the ability of the company

to enter into contracts, without shareholder approval, in takeover situations. This provision is aimed at preventing excessively generous benefits being given to officers of the company. Section 44 proscribes the making of misleading statements. Sections 37 and 38

prevent directors making forecasts of profits or profitability and revaluations of assets, respectively, without the approval of the Commission. These provisions are directed at the risk that directors will misinform shareholders about the performance or assets of the company in their efforts to defeat a hostile bid. Section 23 lays on directors a positive duty to give information to shareholders where the offeror is a major shareholder in the target or where there are common shareholders. Section 60 proscribes conduct or acquisitions which, in the opinion of the Commission, are unacceptable.

Key Factors

15. The definition used in this paper and the outline of the law given above involve three key factors: motive, detriment to shareholders and the effectiveness of defensive schemes. Three questions are raised:

(i) How important is the motive of directors and how can motive be determined?

(ii) Do actions which are apparently defensive cause financial detriment to shareholders? and

(iii) Are defensive strategies and tactics effective over time?

Motive

16. Under the principles set out above, it is the motive of directors which is critical, not the result of their action. If they act in a way which causes financial damage to their shareholders they are nevertheless protected if they acted on the basis of their judgment of what was in the best interest of shareholders.

17. If the legal position is that motive is the key factor, then it raises considerable difficulty in the context of defensive schemes. The first is the problem of proof. The cases have shown that there is rarely conclusive primary evidence of defensive intent. The plaintiff or prosecutor must therefore convince the court that the circumstantial evidence is strong enough to justify the court imputing to directors motives which are not compatible with their duty to shareholders. One result is that relatively few of such cases are brought, fewer are determined and only a minority of those determined actually succeed.

18. Another difficulty caused by the absence of direct evidence is that the circumstantial evidence will often be capable of different interpretations. This is not surprising because business

decisions may be very complex and made for reasons of varying significance. For example, a decision to exchange shares with another comp may be taken mainly to tie up a source of, or market for, raw materials, though it may also make both companies more difficult targets for takeover. As the plaintiff or prosecutor bears the burden of proof, it is rare for the directors to lose an action.

19. A third element, which emerges from the outline of the law above, is the reluctance of courts to substitute their own judgment for that of directors. This judicial policy is grounded in common sense and reflects an appreciation by judges of the limits of their expertise. However the practical result is that, so long as any reasonable business purpose can be attributed to the actions of directors, courts seldom find that any defensive motive which may have been present was so significant as to render improper the directors' exercise of their power.

Detriment to Shareholders

20. It is also hard to establish whether so-called defensive actions or structures cause financial prejudice to shareholders of the defended company. There are several Australian corporate groups which have such strong interlocking shareholdings that they would be difficult takeover targets but which are nevertheless, for the present anyway, providing better than average returns for their shareholders. Likewise there are companies which have open registers and are vulnerable to takeover but are far less profitable. Clearly, good performance depends on far more than being vulnerable to takeover. Whilst there is comparatively little Australian evidence about the impact of defensive measures on share prices there is a growing body of overseas evidence that the introduction of measures widely considered to be defensive does not have a significant impact on share prices. A study, by the Securities and Exchange Commission in the US* found that the introduction of provisions designed to combat two-tier bids (a partial bid to gain control followed by a "mop-up" bid at a lower price) had no adverse impact on the share price of the company. Other US studies** have suggested that so-called "golden parachute" agreements (generous executive severance schemes) have no negative in, pact and may even improve share prices.

21. There is, however, limited Australian data concerning defensive measures taken in the face of an actual bid. A study by the Commission suggests that at least some measure of resistance is likely to benefit shareholders because the offeror is obliged to raise its offer price. This is consistent with some U.S. evidence*** which shows that, in defended takeovers, shareholders realize a significantly higher premium than they do in takeovers where the board of the target does not resist.

* *Securities and Exchange Commission, Shark Repellents and Stock Prices: The Effects of Anti-Takeover Amendments since 1980, October 1985.*

** *Lambert & Larcker, cited in MC Jensen, "Corporate Control: Folklore v. Science", Working Paper Merc. 8404, Managerial*

Economics Research Centre, Rochester, NY at p36.

*** *Kummer and Hoffmeister, cited in M Jensen and R Ruback, "The Market for Corporate Control" Journal of Financial Economics 11, North Holland, 1983.*

Are Defensive Measures Ultimately Successful?

22. This is a significant question for shareholders in companies which successfully resist hostile takeover attempts. There is overseas evidence which suggests that a company which succeeds in fending off one bid stands a high chance of receiving another bid within two years which will be successful. The Commission's own research suggests that this also applies in Australia.

23. It is more difficult to evaluate the success of defensive strategies designed to prevent bids being made in the first place.

The large number of takeovers being made for listed companies might suggest they are not successful though it is unknown how many takeovers have not been made because defensive strategies have been put in place. Changes in the market may well favour offerors. The development of leveraging techniques means that making acquisitions or setting up cross-holdings is now a less effective defence. Also the "up-front" cost of a takeover now appears to be less of an obstacle to an offeror with large lines of credit.

24. However, it is possible that directors Pay deliberately set out to entrench their positions by means of defensive schemes, which raise serious risks of a breach of duty by the directors who implement them and of prejudice to shareholders and investor confidence. It is therefore necessary to consider the various devices which have been asserted to have defensive implications.

Defensive Schemes

25. Defensive schemes may be divided into two groups:

(i) tactics which are adopted in the face of an actual or impending bid.

(ii) strategies intended to pre-empt offers, so that a bid is never made.

However it should be noted that the distinction is not precise because some schemes can be used in either situation.

Defensive Tactics

26. Defensive tactics may be employed when a takeover bid perceived by existing management to be hostile has been made or is thought to be imminent. However it is important to put the phenomenon of hostile bids into perspective. Less than one third of all bids for listed companies in Australia are hostile. By contrast about half of all bids are friendly, in the sense that they are recommended

by directors of the target. (In the remainder directors either make no recommendation at all or the bids are withdrawn or lapse.) This means that defensive tactics are unlikely to be seriously contemplated in the majority of bids. However, it should be noted that the ratio of

defended bids for 1984 and 1985 - 35% - is considerably higher than the ratio for the period 1970-79 when defended bids represented, on average, about 8% of all bids. Thus there has been a marked increase in the propensity of companies to defend bids.

27. Where a bid is actually on foot, the defensive options are constrained by lack of time, the application of Listing Requirements or CASA. Nevertheless a considerable array of defensive tactics is available.

The Commission' s Survey

28. There is little Australian data about defensive tactics. An academic survey covering the years 1970-79' was the only comprehensive published study of which the Commission was aware at the time of preparing this paper.** The Commission therefore undertook its own research, using as a sample all defended bids for listed companies in Australia during the calendar years 1984 and 1985. The categories used are the same as those in the Trotman study and where possible direct comparisons have been drawn. The results are summarised in Table 1.

29. Of a total of 267 bids announced in 1984 and 1985, 94 were defended. The criterion for classifying a bid as "defended" was a recommendation by directors to shareholders to reject the bid.

30. The tactics used by the companies which opposed bids are discussed under the following headings.

(i) Branding the Bid Inadequate;
(ii) Criticising the Offeror;
(iii) Releasing Favourable Information;
(iv) Announcing Higher Dividends or a Bonus Issue;
(v) Placements and "friendly" Purchases;
(vi) Agreed Takeovers;
(vii) Appeal to Suppliers or Employees;
(viii) Appeal to Courts and other Regulators;
(ix) Asset Redeployment.

* *K Trotman, "Takeover Defences by Australian Companies", Accounting and Finance, May 1982.*

** *After the Commission's survey had been completed it received a copy of an unpublished research paper by Roger S Casey and Peter H Eddey of the Australian Graduate School of Management and Macquarie University, respectively, entitled "Defence Strategies of Listed Companies Under the Takeover Code". This paper uses a similar method to that adopted by the Commission except that the sample is larger - it covers the period 1 July*

1981 to 30 June 1985. This may well account for any differences in the conclusions.

(i) Branding the Bid Inadequate

31. This was by far the most common defensive tactic and usually took the form of claiming that the bid was pitched below asset backing or did not allow for the future prospects of the company. Because of the selection criterion adopted this happened in all bids in the survey.

32. Such action may eventually move the offeror to raise its price. At the very least it may encourage shareholders to consider carefully their options and the value of their shares.

(ii) Criticising the Offeror

33. Rejection of the bid as inadequate is occasionally accompanied by criticism of the offeror, especially as to its "opportunism" or perceived lack of competence to run the business of the target company. This occurred in 20% of cases, somewhat less than the 25% recorded in the Trotman survey. It is possible that this difference is due to the subjective nature of the category. There is potential for abuse in such attacks but S.44 of CASA applies to misleading statements made during the course of the bid.

(iii) Releasing Favourable Information

34. This is one of the most common forms of response by defending directors. In this survey it was employed in 61% of cases, compared with 63% in the Trotman survey. The survey by Casey and Eddey found that 71% of defending companies have employed this defence since CASA came into effect. The information usually takes the form of an optimistic review of present or prospective projects or profits and revaluation of assets. However, sections 37 and 38 of CASA require approval of profit forecasts and asset revaluations, respectively. Such profit forecasts are sometimes not borne out but shareholders will have special cause to remember such situations where a bid at a premium on market price failed. This may partly account for the greater likelihood that a subsequent bid will succeed.

35. The Commission has also observed a tendency for defending boards to revalue the assets of the company during takeovers. If this is defensively intended it may nevertheless rebound on directors because it increases the value of the shareholders' investment in the company for the purpose of performance indicators such as return on investment. Directors, if they survive the bid, must then measure up to a higher benchmark. In any event, whatever the motives of directors, the release of more, and more current, information can be of benefit shareholders as they determine their attitude to the bid.

(iv) Bonus Issues and Higher Dividends

36. Another frequent response to a hostile bid is to increase dividends or make a bonus issue, or do both by declaring a bonus and maintaining dividend payout on the expanded number of shares. Dividends were increased in 21% of cases, somewhat less than the 30% recorded in the Trotman survey. 16% of companies made bonus issues, a slight fall from 20% in the earlier survey. Casey and Eddey found only 9% for the period 1980-85. It is possible that shareholders do not benefit by increased dividends in the long term if they deplete corporate reserves and force the company to rely more heavily on borrowing but that is a matter for the business judgment of directors and the shareholders' judgment of their directors.

(v) Placements and "friendly" Purchases

37. The capacity of a company to make a placement once a bid has been announced is limited by Listing Requirement 3R(3) which requires shareholder approval of such action. Nevertheless there may be situations where directors, either because of market rumour, or because they detect unusual activity on the share register, become aware that a takeover offer may be made. In such circumstances a placement may be arranged before any bid is announced. Further, Listing Requirement 3R(3) does not apply to pro rata issues so directors are still free to Fake rights issues. Whilst rights issues need not alter the proportionate holding of an offeror, they may prejudice the success of the bid because they increase the number of shares the offeror must acquire. However, rights issues in the face of a takeover are relatively rare.

38. "Friendly purchase" encompasses buying by both related and non-related persons. It may be made for the purpose of supporting the share price of the target or to accumulate a significant parcel, or both.

39. Both placements and friendly purchase occur consistently in takeover situations. In the Commission's survey they were present in 26% of cases, the same as in the Trotman survey.

(vi) Agreed Takeovers

40. One common result of a hostile bid is for the target company to merge with a different company following a recommendation by the target's directors to accept an alternative bid. This may occur because directors have actively fostered an auction or because the first bid attracts a competitor. The recommendation to accept the alternative bid may be made to defeat the hostile offer or as a result of a perception by directors of the target that one offeror

and its offer are more attractive than another. For the purpose of the survey agreed takeovers were classified as successful defensive tactics in that they contributed to the defeat of the hostile offer. In this survey they occurred in 24% of cases, significantly fewer than the 35% recorded by Trotman.

41. Where a subsequent merger takes place, especially if it is the result of an auction fostered by directors of the target, it is difficult to argue that directors have been advantaged at the expense of their shareholders. Shareholders may have received a higher price for their shares and, in many cases, directors will not gain themselves because the target company loses its independence to its new controllers.

(vii) Appeal to Suppliers, Distributors or Employees

42. These appeals are made to persons or interest groups connected with the target company. They encompass attempts to have franchise or licensing agreements revoked, the enlistment of support from suppliers of material or distributors of product, or employees. One alleged example was the negotiation by Allens Confectionery Ltd. of a termination of employment package with its employees during the offer by Cadbury Schweppes Ltd. The offeror said the agreement was instrumental in its application to the Commission to withdraw its bid. However there is no evidence that this type of defence is common. It occurred in six percent of contested bids in 1984 and 1985 compared with eight percent in the Trotman survey.

(viii) Appeal to Courts and Other Regulators

43. By contrast, appeals to courts and regulators are now common. They usually take the form of allegations that law which is administered by the relevant regulator has been breached. In the seventies appeals to regulators were made in only 18% of takeovers. In 1984 and 1985 they occurred in 37% of defended bids. This may be due in part to the fact that in the seventies the courts were the main avenue available for such appeals. By the time this survey was complied the Broadcasting Tribunal, the Foreign Investment Review Board, the Trade Practices Commission and the NCSC were available. In time-sensitive transactions such as takeovers delay is a major handicap. The offeror's credibility may also be damaged. Since the survey period ended the Commission has noted a marked increase in the number of cases being brought before the courts.

(ix) Asset Redeployment

44. This usually involves the purchase or sale of assets. It is a common occurrence in the face of a takeover, occurring in 19% of the cases in the survey of 1984 and 1985. In the Trotman survey the incidence was 18%.

45. In considering whether directors have acted in the interests of their shareholders in such cases it is necessary to consider the relative significance of the acquisition or disposal. In some takeovers it is so minor that it is unlikely to have much impact

on whether the takeover proceeds or succeeds. In cases where the restructuring is significant there is more suspicion that the

directors are attempting to thwart the takeover. However, it is unlikely that important changes to the business of the company will be decided overnight. It is more probable that the changes will have been in contemplation for some time. Insofar as any defensive motivation is present it is therefore more likely to affect the timing rather than the substance of such proposals.

46. If this redeployment has any demonstrable benefit to the company, such as freeing capital and/or creating n~ business opportunities, regulatory intervention may amount to bureaucratic "second-guessing" of the business judgment of directors. However the Commission is aware of two takeovers where assets which appeared to be particularly attractive to the offeror have been disposed of. In one case the offer failed, in the other it succeeded. This is known in the US as the "Crown jewel" defence. If such action was instrumental in thwarting a bid it may be that directors have failed to act in the best interests of their shareholders.

The Impact of Defensive Tactics

47. Where measures which might have defensive implications are taken in the face of an announced bid there may be reason to suspect that the motive of defending the company from the takeover is uppermost in the minds of directors, unless they are limited to actions likely to raise the price of the offer. However, the fact that a takeover is on foot does not make business decisions any less complex than they are in the absence of a takeover. For that reason it is, in practice, no easier to form a view about the motives of directors once a bid is announced than it is if action is taken before a takeover is made. Given this difficulty it might be more useful to attempt to consider whether shareholders are financially harmed by defensive tactics and the closely-related question of whether defensive tactics actually succeed in the longer term.

48. The data does not appear to suggest that shareholders are necessarily, prejudiced where their directors take action which has defensive consequences. One of the most notable findings of the survey was the frequency of increases in the offer price in situations where defensive tactics were employed. This occurred in 60% of the cases. As the survey did not cover undefended bids it is not known how the incidence of price rises in those situations compares with that in defended bids.

49. Of course, if the takeover is defeated shareholders are unable to realize the enhanced premium at that time so it is relevant to consider the outcome of bids. In 64% of cases in the sample the tactics were successful insofar as they were intended to defeat the hostile bid which gave rise to them. However, it is necessary

to go beyond the outcome of the first hostile takeover and when that is done a very different complexion is cast on the results. Consistent with overseas evidence it appears that a company which fends off one hostile bid will face another bid soon after which is likely to prove successful.

50. In 1984 51% of the defences succeeded. However when later defensive mergers and hostile bids are also considered it is now apparent, less than two years after the survey period ended, that only 12% of the companies which in 1984 received a hostile bid are still independent. In the majority of cases shareholders of the target were able to exit from the company at a price higher than the pre-takeover price.

51. In terms of the outcome of bids, the survey results for 1985 varied significantly from those for 1984. Defences were more successful in 1985 - 74%, compared with 51% in 1984. The 1985 figure is more consistent with the Trotman survey. However, when agreed takeovers and subsequent hostile takeovers are taken into account, a further 33% of target companies which received bids in 1985 have since lost their independence. The consequence is that, less than one year after the survey period ended, 59% of target companies have new controllers. It may be that, by the time another year has elapsed, which will make the post-survey period for 1985 the same as for the 1984 period, this figure will have further increased.

52. The following conclusions can be drawn from a comparison between the Trotman survey and our survey of 1984 and 1985:

(i) Although the majority of bids are not defended there has been a marked increase in the propensity to defend in the 1980' s.

(ii) There has been little change in the incidence of most defensive tactics. In seven out of ten categories the survey results for 1984 and 1985 are within five percent of the survey for 1970-79. The major exceptions are an increased tendency by target companies to appeal to regulators and to litigate and a decreased tendency to enter into agreed takeovers and to increase dividends. (Note -this conclusion differs from that of Casey and Eddey and may be due to the sample chosen and the subjective nature of some of the categories).

(iii) In the majority of cases where defensive tactics are employed, the offeror increases the offer price.

(iv) Defensive tactics tend to have a high rate of success in defeating bids initially but subsequent agreed takeovers and hostile bids which are successful mean that, over time, defensive tactics generally do not succeed in preserving the position of directors (assuming that this was the intention).

Defensive Strategies

53. Defensive strategies are designed to ensure that a takeover is never made, or if it is, that it is at a high price. Some of them have been used for many years, others are comparatively new and developing quickly. It was not possible, in the time available, to gather data about the frequency and effect of such strategies. Any survey would involve setting up control groups of companies which did not employ defensive strategies and there are also difficult conceptual problems such as how to calculate financial loss which may be caused to shareholders because no bid is ever Fade. As a result the following assessment of defensive strategies is qualitative rather than quantitative and definitive conclusions must await further research and longer experience of the newer varieties.

54. Given the high incidence of hostile takeovers in the eighties it is not surprising that more companies have established schemes which may have defensive consequences, irrespective of whether that is the main intention. There has been a consequent rise in the number of complaints being made about them. Many of these complaints have been made by entrepreneurs who are frequent offerors. Insofar as such complaints relate to companies which are alleged to have made themselves "takeover proof" they are cause for concern. Insofar as they are sparked by the necessity to pay higher prices to acquire control of corporate assets complaints are understandable, but the conduct complained of may also benefit shareholders of the target.

55. For the purpose of this study defensive strategies have been classified as follows:

(i) Inter-company Shareholdings between Associated Companies

(ii) Inter-company Shareholdings between Non-Associated Companies

(iii) Obtaining a Foreign Shareholder

(iv) Placements

(v) Employee Share Plans

(vi) Superannuation Funds

(vii) Restructuring Capital

(viii) Re-deployment of Assets

(ix) Article Amendment Defences

(i) Inter-company Shareholdings between Associated Companies

56. It is often asserted that inter-company shareholdings are established for defensive purposes. The Commission suspects that this frequently happens but when Australian examples are examined it is apparent that there are many benefits arising from the establishment of such structures and the extent to which defence against takeovers played a part in the decision to implement them cannot be clearly determined.

57. The structure of the Adelaide Steamship Group is such that the success of any offer for the parent company would depend heavily on acceptance by several major shareholders which are controlled by the parent. However, the structure appears to have developed partly through Adsteam's extensive use of partial bids in its frequent takeover offers. The associates thus acquired have, in turn, acquired other companies and also shares in the holding company. This intra-group investment has often been made by way of redeemable preference shares, a device which brought tax benefits.

58. ICI Austalia Ltd. took at 26% holding in the then Nylex Corp in a move that led to a rationalization of the market for vinyl-coated products and also reinforced ICI's position as a raw material supplier to Nylex.

59. The former Kinnears Ltd. took a 25% holding in Donaghy's Ltd., a New Zealand company, which likewise took a significant holding in Kinnears. Trans-Tasman distributorships provided commercial advantages in a move which also had defensive consequences for Kinnears. If it was defensively intended, it failed. Donaghy's accepted the takeover offer from Johns Perry Ltd.

60. One corporate structure which has been reported to be the result of a deliberately defensive strategy is the Herald and Weekly Times Ltd. It has a complex chain of interlocking holdings with shareholders such as Queensland Press Ltd., Advertiser Newspaper Ltd. and even Gordon and Gotch Ltd., most of which was assembled before CASA came into effect. However the market does not presently appear to regard the group as invulnerable to takeover and it now figures in market and media speculation about potential takeover targets. Bids, mounted simultaneously, for two or even more of Herald's major shareholders, in conjunction with a bid for the parent company, may be capable of success.

61. It is relevant that such structures may only be established in accordance with the threshold provisions of CASA which, in the absence of outright bids, are a significant obstacle to their development.

(ii) Inter-company Shareholdings between Non-Associated Companies

62. There have been reports of more or less formal arrangements between companies, which otherwise have few commercial interests in common, to buy shares in each other should one be subject to takeover or be perceived as vulnerable. Shares may be acquired to provide price support or to amass a strategically significant holding or both. The Commission is satisfied that such arrangements, particularly informal ones, are not uncommon.

63. 'Australia 2000' is a more formal scheme. It was set up by J E Were and Son, a large and long-established Melbourne broker. The structure involved a number of investment companies controlled by Were, one for each participating client, to which funds were subscribed by means of redeemable preference shares. Each of the seven clients contributed $5 million dollars initially and some invested more later. Were invested the funds at its discretion and the investing companies did not know in advance in which shares their money was to be invested. Voting control remained with Were. The stated aim was to provide a vehicle to facilitate long-term investment in leading Australian industrial companies.

64. The structure was designed to avoid infringing the law and the Commission has found no evidence of any breach. In particular, questions of possible infringement of S.129, which proscribes a company purchasing or financing the purchase of its own shares, the substantial shareholder provisions of the Companies Code, as well as section 11 of CASA, have been raised. The Commission is satisfied that no action needs to be taken in regard to these matters.

65. The scheme was established, in part, to make it more difficult to launch successful takeover bids for its members at a low price. It may have provided significant price support for some or all of the companies involved, which may or may not have deterred potential bidders. The Commission is unable to assess the benefit or otherwise of scheme membership to shareholders of the companies involved. It is noted that in only one case did a shareholding exceed 15% of a company's shares - in most cases the amounts invested were below 5%. Strategic holdings were therefore not a significant factor in the scheme. The Commission's report on Australia 2000 is obtainable from the Commission on request.

(iii) Obtaining a Foreign Shareholder

66. One way to stabilize a share register was, at least until recently, to obtain a foreign company as a major shareholder. Foreign investment thresholds have confined individual foreign shareholders to a maximum of 15% unless the Treasurer approved a

higher level. In these circumstances a foreign shareholder could not be a predator. Many Australian companies have or had substantial foreign shareholders. The Commission notes that a wide variety of commercial benefits appear to have arisen from these arrangements and probably constituted a large part of the motivation for them.

67. In the case of Arnotts Ltd., the link with the Campbells food group offers a market for Arnotts products in the US. In other cases there have been benefits to the Australian company in terms of access to foreign technology.

68. It is also worth noting that, whilst the foreign shareholder was unable, without the dispensation of the Treasurer, to increase its shareholding there was nothing to stop it accepting a hostile offer. This happened in the case of offers for Speedo, Gadsden and Kinnears.

69. The recent relaxation of FIRB guidelines makes it less likely that foreign investment will be used as a defensive strategy. It would be more dangerous, given that the foreign company will often be many times larger than its Australian host and the fact that the devaluation of the Australian dollar has made Australian assets much cheaper for a foreign investor.

(iv) Placements

70. Placements are often said to be a defensive weapon, either in themselves or as a means of implementing another defensive strategy, such as obtaining a foreign shareholder. Section 3E(6) of the Listing Requirements of the Australian Associated Stock Exchanges prevents a company issuing shares equivalent to more than ten percent of the shares of the company in any period of 12 months, unless its shareholders approve. This nevertheless permits a company to place substantial parcels, which may amount to a strategic holding, to selected parties without the obligation to obtain shareholder approval. If the placement is made to a "friend" this may add a meansure of stability to the register of the company which makes the placement and, as a result, deter a takeover.

71. However, institutions can no longer be considered reliable holders because increasing competition for investment funds and the frequent rating of the performance of institutions has put pressure on fund managers to improve short-term returns. Some institutions have become very aggressive, taking positions in possible takeover situations and even, in a few cases, making bids themselves.

72. It remains the case that same of the largest institutions are seen as more friendly to existing boards than other institutions. However, in a relatively thin market such as Australia's where currency fluctuations increase the risk of moving investment funds offshore there are structural constraints on the ability of large funds to re-invest funds freed by the sale of shares in a bid. Large institutions may therefore require a higher premium to offset this reinvestment difficulty. Assuming the absence of any special deal

between the institution and the directors of a potential target company, this is simply a commercial decision which is inevitable in a diverse market where some institutions are much larger than others.

73. Where placements are made to parties other than institutions it is frequently because of a strategic relationship. In such cases the exit price of the placee may be higher than that of others because the seller ray stand to lose the benefit of a supply or marketing agreement. To an outside observer the motives for not accepting a bid at a premium on market price may appear defensive whereas the placee may simply be looking to its own commercial interests.

(v) Employee Share Plans

74. Employee Share Plans are often considered to be a valuable means of reducing a company's vulnerability to takeover. Employees will often be amongst the most loyal supporters of the existing management. During recent years employee share plans have multiplied. They are capable of providing both employer and employee with considerable benefits. A long-term identification with the earnings and the share market performance of the company may improve the incentive of and rewards to employees and the profitability of the company.

75. Often the company will make use of the exemption from section 129 of the Companies Code provided for such schemes to lend money to employees or to trustees at low rates of interest, to allow employees to acquire shares over time. The acquisition price is usually at a discount on market price, as is usual for other share acquisition plans such as dividend re-investment schemes. It is common for voting rights attaching to the shares not to accrue to the employee until the shares are fully paid.

76. Most Employee Share Purchase schemes account for only a small proportion of voting shares, usually less than 10%. In only a handful of cases, such as the Lend Lease employee share scheme, is the holding significantly larger. The importance of the holding is likely to differ with the size and age of the company. A small, newly-established company, where the founders are still influential, may be much more susceptible to control by this means. However, in most listed companies which have been in existence for 20 or more years it is unlikely that shares owned by way of employee share schemes will be crucial in the event of a threat to the existing controllers. It is likely that such schemes will continue to be employed mainly for their perceived industrial relations and productivity benefits.

(vi) Superannuation Funds

77. The growth of company superannuation schemes in the post-war period has been stimulated by changes to the taxation system. Superannuation schemes are potential buyers of the shares of the

company which set them up. In the United States companies often manage their schemes and some have been heavy investors in the shares of the company. For instance, when Bendix Corp became involved in a counter-bidding duel with Martin Marietta Corp it was able to bring to its defence more than 15% of its own shares, which were held by the company's superannuation fund.

78. It is far less common in Australia for companies to run their own schemes. In most cases the funds are managed by an institution. Of course, considerable pressure could be brought to bear on the manager especially if the trustees of the scheme are officers or associates of the company, with the extreme threat that it would lose the business if it does not include a certain proportion of the company's shares in its portfolio. However, the Commission is not aware that superannuation funds have often been invested excessively in the shares of the company that generates them, either where the company itself manages them or where a fund manager has been entrusted with them. There are practical reasons for this.

79. Prudent portfolio management requires a diversification of risk and significant investment of superannuation funds in the company can only increase the primary exposure of the employee to the company which arises because he works for it. As the beneficiary of a trust an employee may have ground to sue trustees who are party to excessive exposure of trust funds to the company if the employee suffers loss in consequence. Likewise there may be grounds for action against trustees who refuse to accept a bid pitched at a substantial premium on market price if the share price may subsequently fall sharply.
This dilemma was presented to the trustees of the then Buckley and Nunn superannuation fund during a bid. The trustees accepted the offer.

80. It does not appear that superannuation schemes are a significant obstacle to takeovers. Even where there is perceived to be some defensive impact it would usually be small and, in any event, the trustees are subject to the law of equity, which creates duties which may be inconsistent with the use of superannuation funds to defend a target.

(vii) Restructuring Capital

81. Innovation in financial and securities markets has blurred the once-clear distinction between equity and debt. It has led to the development of securities which share elements of both or derive their value from their relationship to such securities. Convertible notes and bonds, a variety of preference shares and partly-paid shares, as well as options, are now being tailored to meet the specific requirements of different investors and the changing investment environment.

82. As preference shares were made unattractive by inflation convertible notes, which gave investors an each way bet on debt and equity, became more common. However, this also meant that it was reasonable to give note-holders a voice if an event occurred which could fundamentally change the structure, shape or direction

of the company. For this reason many convertible note trust deeds confer on holders an immediate right to convert if a takeover-related event occurs. To the extent that a large increase in the voting capital of a company may frustrate a bid because of the greater cost to the offeror of securing control, notes may have defensive implications. However, for the reason suggested above it would unreasonably

prejudice investors in the company if that accelerated right to convert was removed. As well, the market itself has changed again in such a way as to reduce the frequency of convertible note issues. The removal of double taxation on most dividends will enhance the attractiveness of dividend-derived income to individual investors.

83. On the other hand convertible bonds aimed at an institutional or corporate market are becoming more common. One recent example, an issue by Elders IXL Ltd., was considered by the Commission during its hearing into matters related to the cross investment between that company and The Broken Hill Proprietary Company Ltd. It emerged in evidence that Elders recognised that the bond issue created a significant takeover defence for several reasons. The bonds, being bearer securities, made it difficult for an offeror to know who held them. The bonds might be converted into shares making it more difficult for an offer to succeed. A substantial parcel of the bonds, approximately 65%, was placed into friendly hands. In March 1986, Mr. P. Scanlon [a director of Elders] commented:

"The convertible note issue makes takeover activity far more difficult:

* Acquirer cannot get full control until the notes are converted or unless he acquires all notes. The notes are bearer bonds so that communicating with the holders is difficult.

* Most note holders will not convert for a long period of time and any appreciation of our share price can be realised by selling the bond, the price of which will reflect movements in interest rates, the relationship of the $A to the $US and the share price premium." (Exhibit: BHP 2.5)

It appears that at the time of the issue Mr. J. Elliott [approached] Mr. Wiesener in Monaco, a former director of Henry Jones Ltd. and a friend of Mr. Elliott. Mr. Wiesener was requested to find some holders for the bonds who would be 'friendly' to Elders. Mr. Elliott considered 'friendly' to mean that the holders would probably not sell the bonds without at least referring to Elders, provided the company did well, and would probably also give Elders an opportunity to place the bonds elsewhere.

84. However, even if bearer bonds issued to foreign investors (especially when used in conjunction with interlocking shareholding) do have defensive implications, they may also be an innovative source of finance and thus provide significant commercial benefit to the company.

85. Options to acquire unissued shares may also be given in an attempt to create a potential flood of new equity capital if an aggressor appears. However this assumes that sufficient friendly persons can be found to invest in such securities. As takeover offers need only be made to shareholders registered at the time the offer is made there is no guarantee that their holders will be able to convert in time to get the benefit of the offer if that becomes appropriate. Such a risk may deter would-be friends of the company.

86. It is also apparent that many companies have changed their gearing ratio in the past few years. In most cases they are companies which have traditionally had a low ratio of debt to equity which means they may have a large measure of unused borrowing capacity. Some of that capacity has now been tapped and the proportion of debt to equity in the balance sheet has risen. This may be a defensive move insofar as a number of active offerors are perceived to have highly-geared businesses and to make highly-leveraged takeovers. The acquisition of a low-geared target may reduce the average gearing of the offeror's group and help the offeror roll over funds required to pay for the acquisition. In this context, a company which considers it may become a takeover target could reduce the chance that this will occur by gearing up.

87. However such a move may directly or indirectly provide shareholders of the company with major benefits. By taking advantage of the tax deductibility of interest payments it may improve earnings per share. It may help fund an expansion or diversification of the business of the company. From this perspective such action permits the "asset" of unused borrowing capacity to be tapped for the benefit of existing shareholders rather than for the offeror.

(viii) Redeployment of Assets

88. A large number of listed companies with diverse or discrete businesses have recently floated them off into separate subsidiaries. Two examples are McPhersons' Ltd. and Westfield Holdings Ltd. This may have the effect of making offers for the group a more complex process than would have been the case had the subsidiaries not been spun off. However there are often clearly identifiable commercial benefits from such a practice. It may allow management to concentrate on a core business and give the market a better understanding of the risks and rewards associated with each business. The implementation of dividend imputation is also expected to allow shares in the subsidiary companies to be distributed to the shareholders of the parent company as a tax free dividend, assuming that the company has paid sufficient tax.

89. Important assets could be placed into joint ventures which gives partners a right of withdrawal if an unacceptable party acquires control of the manager. Licence arrangements or supply arrangements which are determinable in the event of a takeover may have considerable deterrent value in the event of an unwanted bid. The Commission is aware of cases where determinable franchise arrangements have been called in aid by a target company, but the outcome of the bids appears to have been decided on broader grounds. As to motive, the experience of the Commission is that such arrangements are usually made for commonly accepted commercial

reasons. Any defensive intention, if it is present, is not obviously important.

90. Sometimes assets of the company are disposed of. Where it has the effect of denying to a potential offeror an asset at which a bid may be particularly aimed, it raises the suspicion of a "crown jewel" defence. However the sale will usually bring liquid funds into the company, which can be used for other purposes.

91. Where an asset is acquired there may also be defensive consequences, especially where it is funded by the issue of shares. Any offeror would therefore have to acquire a greater number of shares, with a consequent increase in outlay, to achieve control.

92. These transactions are always subject to the law relating to directors' duties and, in some cases to Listing Requirements as well. For instance, where the company proposes to sell to, or acquire from, an associate assets equivalent in value to five percent of the total issued capital the approval of shareholders (who must be supplied with independent valuations) is required. The valuations are also subject to scrutiny by Stock Exchange officers.

(ix) Article Amendment Defences

93. Amendments to a company's Articles of Association are one of the fastest growing innovations in defensive schemes. These may be made by means of a special resolution of members which requires a 75% majority. There are some companies such as AWA Ltd. which have long-established amendments which appear to deter takeovers. However the recent trend was started by companies which voiced concern about the possibility that they might lose business opportunities in Australia if they were classified as foreign companies for the purpose of the Foreign Takeovers Act because of the level of foreign shareholdings. Western Mining Corporation was amongst the first to insert an article entitling it to refuse to register transfers if the STA could be breached. The move was not welcomed by Stock Exchanges because of the potential fetter which it represented on the market. However Western Mining, the former Myer Emporium Ltd., ACI International Ltd. and McPhersons Ltd. which followed suit, were not delisted in consequence.

94. It was speculated that the Myer article could be a considerable handicap to the bid in 1985 from G.J. Coles & Co. because Coles had a large foreign shareholder in the form of Kresge of the US. In the event the parties negotiated a higher price and the point was never taken. However ACI did take it in relation to the bid for it from the New Zealand-based Equiticorp group. The Supreme Court of Victoria held that ACI was empowered by the article to refuse to register transfers which would make Equiticorp the holder of more than 15% of the company's shares.

95. In relation to partial bids, the 1986 Companies and Securities amending legislation formalized a mechanism whereby companies can protect themselves against unwanted partial bids by amending their Articles. The amendment will enable companies to require approval of the bid by a majority of shareholders (obtained by means of postal ballot or in general meeting), failing which the company

may refuse to register the offeror's share transfers. However the legislation includes the important safeguard for future shareholders that any such amendments may not endure beyond three years. North Broken Hill Holdings Ltd. has already inserted an article taking advantage of this provision and other companies have given notice of their intention to do so.

96. So-called "Poison Pills" are widely used as defensive strategies in the US. They are usually issued in the form of a right attached to existing ordinary shares to take up another ordinary share. Until the occurrence of a takeover-related event these rights trade with the ordinary shares and are not represented by a share certificate. However when a triggering event, such as the acquisition by a person of a major shareholding (usually 20%), takes place they are exercisable at a predetermined price. They are mainly directed in the US at front-end loaded and partial bids but are less effective against 100% cash bids. They can cause a huge increase in the number of shares an offeror needs to acquire to secure control.

97. It does not follow however that there is likely to be a flood of such shareholder-approved defences because there is no legal barrier to them. Institutions, which are large shareholders in most listed companies, are unlikely to favour them. The Stock Exchanges may also refuse to list, or might proceed to delist, any company which introduces them. It has also been suggested that Australian companies might follow the lead of American companies and introduce such articles but this does not take account of the major differences in the regulatory system in the US where takeovers are far less regulated than they are in Australia. For example, two-tier front-end loaded bids, against which many of the US amendments are directed, are not legal in Australia. If the abuse does not exist, the counter-measure will not be needed.

98. The United States Securities and Exchange Commission has for same time being reviewing various issues relating to corporate takeovers. As part of this review process the Commission determined not to take or recommend actions that would prohibit a range of defensive measures. Refer to Attachment 2 - an extract from a letter dated 17 January 1986 written by SBC Chairman John Strad to the Hon. Timothy Wirth, Chairman of the U.S. House of Representatives Subcommittee on Telecommunications, Consumer Protection and Finance.

Conclusions

99. This paper has considered same of the strategic and tactical uses of defensive schemes. It concludes that:

(i) tactical and strategic measures which have defensive implications are common;

(ii) it is very difficult to determine whether defensive motives predominate when directors decide to introduce these measures;

(iii) although the majority of bids are not defended there has been a marked increase in the propensity to defend in the 1980's;

(iv) there has been little change in the incidence of host defensive tactics. In seven out of ten categories the survey results for 1984 and 1985 are within five percent of the survey for 1970-79. The major exceptions are an increased tendency by target companies to appeal to regulators and to litigate and a decreased tendency to enter into agreed takeovers and to increase dividends.

(v) in the majority of cases where defensive tactics are employed, the offeror increases the offer price;

(vi) defensive tactics tend to have a high rate of success in defeating bids initially, but subsequent agreed takeovers and hostile bids which are successful mean that, over time, defensive tactics generally do not succeed in preserving the position of directors (assuming that this was the intention).

100. Defensive conduct by target companies raises important and complex regulatory issues. For example, it is clear that not all defensive measures are detrimental to the interests of shareholders -defensive tactics are frequently associated with an increase in the offer price, the emergence of an alternative bidder and/or the release of "new" information about the target. Under these circumstances, where, in the judgment of directors, there is a reasonable probability that defensive measures will increase shareholder welfare, their duty to shareholders obliges them to take such measures. On the other hand, some types of defensive measures, especially those described as defensive strategies, may well be detrimental to the interests of shareholders in particular and the securities markets in general. They might involve losses to shareholders by reducing the probability that a bid will be made and/or by reducing the value of a bid. Although the material available on defensive strategies is rather scanty it does appear that many companies which employ defensive strategies do eventually receive takeover bids and to this extent market forces seem to be operating to ameliorate some of the detrimental consequences. However, even if market forces do eventually operate, the strategies may still be imposing costs which not only reduce shareholder returns but which also impair the allocative role of the securities market. In such circumstances remedial regulatory action would appear to be warranted.

TABLE 1

DEFENSIVE TACTICS BY LISTED AUSTRALIAN COMPANIES 1984 AND 1985

PRELIMINARY RESULTS

TOTAL NUMBER OF BIDS	1970-79	1984		1985		1984 & 1985	
	%	No. 138	%	No. 129	%	No. 267	%
BID INADEQUATE	100	41	100	53	100	94	100
CRITICISMS OF OFFEROR	25	7	17	12	23	19	20
FAVOURABLE INFORMATION	63	31	76	26	49	57	61
INCREASE DIVIDENDS	30	14	34	6	1	20	21
BONUS SHARES	20	10	24	5	9	15	16
FRIENDLY PURCHASE/PLACEMENT	26	10	24	14	26	24	26
AGREEMENT TAKEOVER	35	11	27	12	23	23	24
APPEAL TO SUPPLIERS/EMPLOYERS	8	5	12	1	2	6	6
APPEAL TO COURT/REGULATORS	18	17	41	18	34	35	37
REDEPLOYMENT OF ASSETS	18	8	20	10	19	18	19
PRICE RISE	-	26	63	30	57	56	60
SUCCESS OF TACTICS	76	21	51	39	74	60	64

ATTACHMENT 1

THE IMPACT ON SHAREHOLDERS OF SCHEMES DESIGNED TO PREVENT TAKEOVER BIDS

5 September 1986

Robert N. Johanson
Macquarie Bank Limited

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CHAPTER 1

SUMMA RY

1.1 Brief

The Ministerial Council for Companies and Securities has directed the National Companies and Securities Commission to consider whether directors involved with defensive schemes may not be acting contrary to the best interests of their shareholders. This report has been prepared to assist the NCSC in advising the Ministerial Council.

The concern of Ministers arose from the Commission's enquiries into the so-called "Australia 2000" Club. However, it is believed necessary that the Council be advised in relation to a much broader range of defensive schemes. The particular focus of this report relates to pre-emptive strategies designed to ensure that bids are never made. Strategies or tactics which might be adopted when a bid is imminent or has already been announced, are not covered by this study.

1.2 Conclusion

Our conclusion is that pre-emptive defensive strategies which seek to build artificial walls around the company and to prevent any bid occurring are ineffective. We do not believe that over time such strategies can work to entrench management at the expense of shareholders.

If a company does seek to build artificial walls around itself as protection against takeovers and its economic performance is not adequate, then the costs of capital to that enterprise will increase and its share price will fall. When the potential value which might be released exceeds the costs of overcoming the hurdles, it will again become a prospective target.

In this paper we have avoided trying to assess the effectiveness of defensive strategies such as are discussed simply by relating them to just one bid or one event or over any short period of time.

The very limited history that we have available to us in relation to the market for corporate control as regulated by the Company Acquisition of Shares Code does, we believe, tend to the conclusion that market forces are effective in working out this cost/benefit analysis. Ultimately it does seem to impose the discipline of a market place even on managers and Boards of Directors who seek to entrench themselves at the expense of their shareholders by the adoption of such defensive strategies. Indeed, we would be

concerned that any action against such strategies would have the effect of impeding the use of the techniques for entirely proper purposes.

In view of this, it is our conclusion that no action by the Ministerial Council in relation to the kinds of pre-emptive defensive strategies outlined in this paper is required or warranted.

CHAPTER 2

BACKGROUND

2.1 Definition of Defensive Strategies

It is said that the best defence against a takeover is to have a high share price. The logic behind the remark is, of course, that if the price of the company's securities reflects as much value as might be expected to be extracted from the assets owned by the corporate entity, there will be no economic advantage to an acquirer in taking control of those assets through the takeover process. However, like most trite observations, it is true in only a limited range of circumstances and assumes that an offeror will assess "economic advantage" according to the same criteria as the market place. It will not do anything, for example to dissuade a party which might see cost savings to be generated by combining assets of two companies or who might have access to a lower cost of funds for some reason.

The observation is recorded here because it could be said that anything which is designed to promote a better share price could be defined as defensive in the broadest sense. Investor relations programmes, for example, designed to sell the company to prospective and existing investors with the intention that they will value the assets or businesses of the company and hence its shares higher are in this sense an obvious defensive strategy. But clearly, this is not the sort of scheme which is meant to be covered by this study and which is of concern to the Ministerial Council.

Therefore, we have defined defensive schemes for these purposes as

"building artificial walls or protective fences around a company with the intention of preventing market forces operating through the ordinary mechanisms of the market for corporate control exercising discipline over the Board of Directors and Management".

We are concerned with strategies designed to entrench existing management and the Board of Directors at the expense of shareholders.

2.2 Outline of Report

In chapter 2 of this paper we discuss in some detail a variety of strategies and techniques which might be used to build a company's defences against takeovers. They include interlocking shareholdings, amendments to articles of association, restructuring of businesses to create associated companies and

issuing derivative securities. In no sense is this an exhaustive list of potentially defensive strategies that might be adopted. However, it does cover the major areas and our conclusions are we believe likely to be equally applicable for other varieties of such strategies. Some require approval by shareholders and the implications of this are discussed in Chapter 3.

In each case, the strategies we discuss might be adopted for a variety of reasons. No doubt there are instances where a major reason for their introduction has been to assist strengthening the company's defences against an unwanted takeover, or at the very least, been designed to ensure that any

bid will need to be made at an appropriate premium. But, as well, in each case there will be many instances where defensive strategies were at most a minor factor in the decision making process. In many of the strategies identified and discussed there are very good commercial reasons why in particular cases they might be adopted. It is clear that in this area there are real problems of identifying motives and being able in any sense to assert with certainty that the dominant motive was to build artificial walls or protective fences around the company and to entrench the existing board of management at the expense of shareholders. A company will undertake any action for a variety of reasons and each director will have his or her own particular reason for committing the company to the action.

To seek to impute motives merely from the existence in any company of one or more of the strategies identified here as potentially defensive would be dangerous and wrong. It would be contrary to the principles of the business judgement rule as it has been developed by the courts in relation to directors duties. This is discussed at greater length in Chapter 4 of this paper.

2.3 Criteria for Acting Against Strategies

However, even if it were concluded that the existence of a particular strategy presented an overwhelming case for the existence of motives to build artificial walls or protective fences, it does not follow that it is necessary to act in any legislative or regulatory way against such a strategy. This only follows if the strategy were indeed successful in its alleged objective of entrenching the existing board and management at the expense of shareholders and if shareholders did actually suffer financial prejudice as a result. Unless each step can be established our belief is that no case for legislative or regulatory change can be made out.

2.4 Problems with Establishing Criteria

In relation to making such assessments we offer these following observations:

* **Empirical Research of Doubtful Value**

To determine whether or not actual financial prejudice is suffered as a result of these schemes, it would be necessary at the very least to conduct extensive and detailed data based empirical research. This would presumably involve comparing companies which were and which were not involved in such strategies and determining whether a clear case could be made out that those companies which were involved in those strategies performed worse as a result and so caused financial prejudice to their shareholders. We do not

believe that such a study would be worthwhile as we are confident that its results would be, at the very best, ambiguous and susceptible to the methodology adopted. Council will be well aware of the debate concerning recent studies as to the general economic benefits of takeovers themselves. At the very least, we believe there is a fair degree of scepticism about such studies and their usefulness.

*** Ability of Markets to Adapt**

Any such study can only capture its evidence and present its conclusions relevant to a particular market at a particular time. The capital markets have, over the last ten years undergone tremendous

change. The internationalisation of most capital markets, the proliferation of direct and derivative securities to allow very sophisticated strategies for the management of risk to be developed and employed, an abundance of finance available to fund a wide range of what would have been considered 20 years ago extremely speculative and high risk ventures - all are obvious indications of the degree of this change.

More narrowly and within the confines of the general area being discussed in this study, there has also been considerable change. The regulatory framework in which takeovers occur changed fundamentally with the introduction of the Companies Acquisition of Shares Code in 1981 and the market has adapted to that regime in the subsequent five years. For example, in the early years of the operations of the code, pro rata partial bids were generally considered to be so effective as a way of forcing shareholders to deliver control to the offeror that they could not be defended against in the absence of a better competing bid. Even before the introduction of regulatory changes which reduced the element of competition amongst shareholders by preventing bids from being pro rata and directing that they all be proportional, we believe that shareholders were becoming more sensitive to the coercive element of such bids and less likely to be intimidated by them. A number of pro rata bids over the past year have proved to be unsuccessful where we expected that if they had been launched four years ago, they would have been more successful for the offeror. Similarly, we believe that a number of strategies which we will classify as potentially defensive and which some years ago were probably seen as being entirely successful and inuring the company concerned entirely against the prospect of a hostile takeover no longer work. The most obvious example of this concerned interlocking shareholdings amongst associated companies.

The market itself has been able to develop to deal with particular issues established by regulation and defensive strategies. Where the balance of power in relation to economic forces is altered from time to time by the development of new strategies or the imposition of new regulation, economic forces will drive to solutions which redress those distortions. The clearest example of this in relation to interlocking shareholdings in the Australian context is probably the defensive structure established by the Herald and Weekly Times Group which is discussed in more detail later in this paper.

It is now commonly accepted that the Herald and Weekly Times would be vulnerable to a takeover bid, or at least takeover bids mounted simultaneously for the key elements in the group of companies concerned. This company is generally perceived not to have performed as well as others in the media industry such as News

Corporation and its assets have not been acquired by the entrepreneurs who over the past few years have sought to acquire such assets at what have seemed to be prices well above the values being realised by the Herald and Weekly Times for its shareholders. However, there are no doubt a number of reasons for this relative performance and to seek to apportion the blame for such financial prejudice, (even if that were able to be established) amongst relative product strategies, market strategies, investment strategies etc as well as defensive strategies seems to us to be futile.

*** Changing Fashions in Corporate Strategy**

A strategy which may be characterised as likely to be defensive in one market environment may be seen to be innovative and financially very aggressive in delivering value to shareholders in another market environment. For example, we suspect that if some years ago a company had sought to establish an associated company through the divestment of, say, 60% of the shares in what had been a wholly operating subsidiary to the public and the creation of a newly listed entity, it might have been seen as potentially defensive.

The trend then was in favour of consolidation of such separately listed or independently owned subsidiaries or associates. For example, CRA which had been created as a holding company to sponsor the creation of and to continue to hold substantial investments in listed entities with single projects (such as Hammersley Iron and Bouganville Copper) had sought to integrate entirely some of those separate entities. There were, under the tax regime that then applied, very strong financial reasons for doing so and no doubt there are also good reasons relating to management cohesion and in corporate planning. In that environment if a company had established such a separately listed entity out of what had been a wholly owned subsidiary, cynics might have believed that it was being established to allow for cross shareholdings.

However, we have over recent years seen in the United States the emergence of a huge industry relating to leveraged buyouts. A major focus of the operators in this new business are the opportunities for large publicly listed companies to divest themselves of non-core businesses. Very substantial companies have been acquired through leveraged buyouts with, in many cases, companies then being split up into the various elements some of which are sold off and some of which may re-emerge as new listed entities.

A strategy available to aggressive management acting in the interests of their shareholders would be to conduct such a divestment programme themselves and so return any benefits to be gained directly to shareholders rather than waiting to be acquired via an LBO which may leave the added value to be generated from the divestment programme in the hands of the acquiror rather than the existing shareholders. The existence of such non-subsidiary separately listed or separately owned entities may well mean that another party with vital interests could in the context of a takeover become a prospective buyer of shares in the parent/target. But even the motives for that buying, if it were to take place, could not be necessarily prescribed to be defensive. As it turned out, the buying by Elders IXL of shares in its 49% owner Carlton and United Brewries turned out to have little to do with seeking to protect CUB against a hostile takeover.

2.5 **Effectiveness of Defensive Strategies**

There is a saying in the United States investment banks that, once any sort of credible takeover offer has been made for a company or once a credible acquirer announces or is discovered to have collected a strategic shareholding, the company is "in play". On way or another, the company will then be taken over or be irrevocably altered. The world will never be the same for such a company. The study of takeovers of listed companies in Australia in 1984 by Geoff Robertson of the NCSC, demonstrates that this remark applies here too.

The existence of defensive strategies which have been put in place to dissuade offerors from seeing the company as a prospective target has in our experience never been determinative of whether or not a bid ought to be made. Interlocking shareholdings between associated companies and sliding scale voting rights are perhaps two of the most effective defensive strategies which could be adopted. Yet where the interlocking shareholdings have been established purely for defensive rather than real economic or other reasons, it now seems that the usefulness on this criteria may turn out to be quite limited. We discuss this point in some detail later on. The existence of a sliding scale voting rights structure in AWA has not finally deterred Universal Telecasters from making a bid. Indeed, we believe that there are probably technical solutions to the difficulties caused to offerors by such techniques.

CHAPTER 3

IDENTIFICATION AND ASSESSMENT OF STRATEGIES

3.1 Introduction

In this chapter we discuss certain strategies that have been identified from time to time as defensive strategies and which may form part of attempts by companies to build artificial wails or protective fences with the intention of preventing market forces operating through the ordinary mechanisms of the market for corporate control and so exercising discipline over the board and management. In each case we describe briefly:

* how the strategy might be implemented;

* what potential defensive implications the adoption of such a strategy might have;

* what are the possible motives a company might have for their adoption;

* what regulations are relevant;

* whether such strategies can be seen to have been a success or a failure on defensive grounds; and

* whether it can be settled that shareholders have suffered financial prejudice as a result of the adoption of such strategies.

The list of strategies which are discussed here are no doubt not exhaustive of the varieties of protective plans that companies have considered or have implemented in the recent past. However, we believe that the list is fairly comprehensive and in general principle, most of the major areas of possible concern to the Ministerial Council will have been covered.

We are not suggesting that in a discussion with a company concerned about its possible vulnerability to takeover, only these things would be discussed. For example, we do not consider here techniques for improving earnings per share through the more aggressive use of financial instruments or tax efficient forms of financing. Such techniques may possibly improve the earnings performance for the company as reported to or is relevant for shareholders and so may improve the share price of the company. Any such action could be seen in the broadest context as "defensive". However, such strategies do not fit within the definition artificial and protective defensive schemes as defined at in chapter 1 of this paper.

It should also be noted that a very considerable mystique and even romanticism surrounds much of the public discussion of these matters. Observers with even just a passing interest in this area of capital markets will be familiar with such enticing terms as "poison pills", "shark repellants", "golden parachutes", "white and black knights", "neutron bomb defences" etc. This exotic jargon is largely derived from the United States where it is promoted by the small circle of advisors to increase the aura that surrounds a profession which already has enormous barriers to entry. Such ill defined jargon no doubt helps to promote their own exclusivity. It also promotes suspicion in the minds of outside observers unfamiliar with

the real nature of these transactions. In fact, these devices are conceptually fairly simple and fall within the headings set out here.

3.2 Interlocking Shareholdings Between Associated Companies

A number of companies or corporate groups have established shareholding structures so that in respect of any individual member of the group, a considerable proportion, up to 50% in each case, of the shares of the company are held by other associated companies. The best known examples are probably the interlocking shareholding structures of the Herald and Weekly Times Group, the Adelaide Steamship Company Ltd. Group and the News Corporation/TNT/Ansett groups. There are other examples but these three seem to cover the main principles relevant to this discussion.

In these three examples, the interlocking shareholdings have grown up or been established in quite different circumstances:

* The Herald and Weekly Times Group structure was established as a direct consequence it would seem of the strategy adopted by the board to make the companies impervious to takeovers. After the various forays into the share register of the The Herald and Weekly Times in the late 1970s by, for example, the Bell Group, the company took action to reduce its vulnerability to takeover. Clearly, considerable resources were dedicated to this purpose and interlocking shareholdings between The Herald and Weekly Times Company Ltd., Queensland Press Ltd., Adelaide Advertiser Ltd. and various other smaller companies were established. When Gordon & Gotch Ltd. became the holder of a substantial parcel of Queensland Press convertible notes, Gordon & Gotch itself became the subject of acquisition by The Herald and Weekly Times to protect what was identified as the "weak flank". Gordon & Gotch eventually became owned as to in excess of 40% by the Herald and Weekly Times as a result of a shareholder approved acquisition of shares pursuant to s.12g of the Companies Acquisition of Shares Code following the acquisition of Gordon & Gotch plc. Throughout the establishment of this structure, the reason it was being created was well publicised and we suspect that the entire market was on clear notice that this was the intention of the company.

* The structure surrounding the Adelaide Steamship Company Ltd. group was created in different circumstances. Adsteam under the control of Mr. John Spalvins became an aggressive corporate acquirer which used the techniques of the pro rata partial bid extensively in the early 1980s to acquire significant and controlling stakes in a wide variety of companies. After acquiring these significant but minority holdings, very often those newly acquired companies were themselves used to make partial takeover

offers for other companies. Many of these companies were then used, in turn, to buy shares in each other. It is now commonly accepted that Mr. Spalvins has proved extremely adept at managing assets which were not performing well. Certainly the common perception is that many of those shareholders who did not accept takeover offers but have remained as minorities have done extremely well. As well as the shareholdings between the various members of the Adelaide Steamship group, there has been considerable investment from company to company by way of redeemable preference shares to allow financing amongst the group in a tax efficient form. This has made any accurate assessment of the creditworthiness of each member of the

group somewhat difficult though there is no suggestion that funds were never available to the company.

* The News Corporation/TNT/Ansett group holding came into being as a result of the acquisition of Ansett Transport Industries by News Corporation and TNT. Ansett owned significant transport and media interests and so the two acquirers had interests in separate parts of the acquired company, though in fact News Corporation has retained its interests in Ansett Airlines.

In each of the three examples described above, it appeared at the time that the structure made the various members in the group unable to be taken over. There was always the potential that other significant buyers could emerge in the market place to force the price up and to prevent strategic parcels being acquired. However, in at least two of the cases, it seems entirely plausible that the circumstances and motives leading to the creation of the structure were not driven by purely defensive purposes. The relationship between News Corporation and TNT was formed in effect to enable them to get access to the separate assets of Ansett in which each was interested. The fact that the relationship continued and, in part as a result of the various legal actions instituted by the NCSC in relation to the structure, the nature of the relationship, at least in a formal sense, changed significantly.

The structure as it developed in relation to the Adelaide Steamship group has allowed for a considerable redeployment of assets, both financial assets and operating assets, inside and outside the group. It might be argued that such a flexible structure was necessary if the degree of restructuring and redeployment of the assets which had been acquired were to be properly effected.

In relation to interlocking shareholdings between associated companies, the provisions of the Companies (Acquisition of Shares) Code relating to associates and entitlement are relevant. These provisions are particularly wide and, on the face of it, would prevent such structures being established except in compliance with this regime. The structure of the Adelaide Steamship company group was established by way of the use of takeovers themselves with the various members in the group sequentially making takeover offers and then acquiring shares to which it might have already been entitled. The provisions as widely argued and prosecuted by the NCSC in the News Corporation/TNT/Ansett case resulted directly or indirectly in that structure being recast.

In the case of The Herald and Weekly Times, the structure was largely established before the institution of CASA. Numerous steps which have occurred in the adjustment and consolidation of the group and its structure have been in compliance with the Code.

Such interlocking shareholding structures have been seen as the most obvious and successful of the defensive strategies. However, it is interesting that now these structures are often being unwound or are perceived to be themselves a source of weakness. As defensive strategies complete in themselves, they are no longer seen as being entirely successful.

Where a group of companies each holds shares in each other, it is now argued that for directors to continue to act as though the companies which own

shares in their own company and in which they in turn own shares i.e. shareholders to whom duties are owed is too simple. The argument is that it is only the outside shareholders to whom duties are owed. At the very least directors may be vulnerable to court action preventing them acting in ways which might be seen to be contrary to the interests of those outside shareholders.

Clearly this dilemma will arise for those directors when a takeover for any part of the group or all of the groups simultaneously might be announced. The willingness of possible acquirers to be very aggressive in using litigation as a very active part of a takeover strategy and in particular in relation to the provisions of the Takeovers Code, there may be grounds for arguing that such defensive strategies are not and will not be conclusive. But such interlocking shareholding strategies are probably breaking down more swiftly for other reasons.

The strategies have caused other pressures or been part of causing other pressures to fall on the companies involved. In the case of the Herald and Weekly Times, what was seen as the preoccupation with the possibility that the company might be taken over was a factor in the relatively poor performance of that company compared to other participants in the media industry. The cost of capital, both equity and debt, was for this company clearly higher over this period than it was for other more aggressive players. This implies that shareholders may have suffered some financial prejudice as a result of such strategies.

However, as was discussed above, the strategy and the shareholding structure was put in place over time. The motives were quite public and any shareholder who disapproved was able to dispose of his or her shares during that period. If the analysis of the financial prejudice which might have been suffered is made on a day to day basis (and a decision not to sell or to be taken for these purposes as being as relevant to the assessment of the level of any financial prejudice as a decision to buy), it is difficult to argue that at any one period of time, any significant prejudice was suffered. Over time this strategy may in part have resulted in the cost of capital to the company being increased in relation to the asset base of the company (which is another way of saying that the earnings performance on those assets was lower or the ratio of the price of new equity which could be issued in relation to those earnings was lower than for other companies). The fact that another party may have been dissuaded from making a takeover offer for those assets because of the interlocking shareholding structure is itself likely to mean that shareholders would demand a higher return which will be generated by lowering the price.

It may be argued that the community as a whole has suffered as a result of those assets not being managed by other parties who might have extracted greater value from them. The interest of the wider community goes beyond the scope of this paper and indeed go beyond the scope of the duties of the directors. It is sometimes argued that directors may be said to have a duty to more than simply their shareholders and so that duty may extend to creditors employees and other members of the community in general. However, such extensions of the duties of directors are at present at least fairly generally stated. Suffice to say that we are unsure how such duties might be enforced, at least in the context of the particular issue we are here discussing.

There are numerous other examples where several companies have held shareholdings in each other but which have not proved conclusive in the event of a takeover. Very often the shareholding relationship will have been established as a result of a business link such as a supplier, customer, licensor or licensee. But while such a relationship may be the reason for the establishment of the shareholding and may result in the shareholder being more reluctant to sell, that relationship has never proved conclusive as to whether or not to sell whatever the offer price or whoever the offeror.

* Kinnears Limited held approximately 25% of Donaghy's Ltd. of New Zealand which in turn held shares in Kinnears at the time Johns Perry Limited bid for Kinnears. The companies participated in distributorships together. Donaghy's accepted the offer.

* R.M. Gow Ltd. was owned as to 12% by Bundaberg Sugar Company Limited at the time of the bid by Nicholas Kiwi Australasia. Bundaberg supplied Gow with raw materials. Bundaberg sold to Nicholas Kiwi.

Interlocking shareholdings between associated companies are perhaps the best example of a strategy seeking to protect the company against the threat of takeover. We have discussed a number of examples and have concluded that even where that motive has been publicly announced and would seem to have been most effectively implemented it is not clear that the strategy proved to have been complete in the long term.

We have also argued that it is very difficult to establish whether or not financial prejudice has been suffered by shareholders as a direct result of such a strategy. It may be possible to postulate an example of a shareholder who acquired shares many years ago, then disappeared for a long time and some years later has discovered that he has suffered financial prejudice as a result of the company being preoccupied with defensive strategies in the meantime. But of course, simply because a company is vulnerable to takeover does not mean that it will perform well, just as being invulnerable to takeover does not mean that poor performance is assured.

3.3 Interlocking Shareholdings Between Non-Associated Companies

There have been suggestions from time to time of arrangements existing between companies whereby those companies each agree to buy shares in each other should one be subject to a takeover or be seen to be particularly vulnerable. The companies in these arrangements are generally seen to have no particular business relationship with each other but are drawn together simply out of fear of being taken over. The buying between the companies would

be organised and structured so as to attempt to ensure that no legal "association" exists between them for to allow such a relationship to develop might impede the flexibility of the target in relation to other actions.

Rumours of these schemes have been common for a long time with the two best known varieties being the "Australia 2000" group and the "Sydney Wheel". The Ministerial Council has already received a report in respect of the Australia 2000 group. The alleged Sydney Wheel is said to comprise a loose group of companies whose senior executives have social connections and members of which from time to time have acquired shares in each other.

Some of the share buying discussed in that report and associated with these groups has taken place when a bid has already been announced. That aspect of it is beyond the purview of this report. The earlier report to the Ministerial Council also identified some buying which occurred in companies which were not necessarily the subject of an imminent or actual bid but had been commonly identified as "prospective targets". This buying is presumably to support the share price and prevent it falling to the levels where the company becomes a potential target or to collect holdings large enough to be significant in the event of a bid.

The usefulness of these buying arrangements in relation to defending a company against an unwanted takeover will be limited by the amount of funds that are likely to be able. In no instance disclosed in the previous report to the Council was the holding in aggregate more than 15%. In general, the holdings were much less than that and in the context of each company reported on was a relatively trivial amount in proportion to total funds under management.

We believe it unlikely that large amounts of funds can be marshalled this way to allow the accumulation of significant shareholdings. Any effort to support share prices for any substantial period at levels above prices the market will bear is likely to quickly become expensive. In no instance of which we are aware has such pre bid buying by friends ever proved crucial in an eventual takeover.

This situation may be different once the bid is on the table, for by then it is likely that the market trading will be very active and volatile and subject to quite substantial swings on relatively small volumes. Where the balance of power is evenly poised such buying may become significant. However, in the situation which is the subject of this report, that is buying before a takeover is seen to be imminent, we doubt it will be significant.

There are a number of good reasons why companies will generally be reluctant to commit substantial funds in exercises of this nature. In general, the return on the investment is likely to be quite poor. This is particularly so because of the very nature of the deal which seems to require that shareholdings not be sold at a profit in the event of a takeover bid. On the other hand, the degree of risk associated with the investment is, like all investments in such volatile situations as potential takeovers, quite high. Directors, we believe, will be unlikely to allow the financial performance of their own company to suffer unduly in making such investments.

For a company which is likely to be the subject of a bid, the promotion of such a scheme can be quite consistent with the duties

of the directors to act in the best interests of their shareholders. If they believe that they are promoting an active market for their securities then by involvement with and promotion of such schemes ensuring active buyers, then they may be quite properly doing no more than ensuring that a bid is made at an appropriate price. Such buying is unlikely to be effective in this except at the margin and in our experience will never be determinative.

The history of friendly buying in relation to takeovers is replete with examples where, in the terminology of the journalists and insiders, white knights have turned to black knights. The general view amongst advisors is

that there is no such thing as a white knight and several notable examples in Australia recently would seem to confirm this view. Companies taking positions in other companies in the midst of a takeover or in anticipation of a takeover will be always keen to ensure that it does not merely promote their own vulnerability. Thus, they will be anxious to protect their own economic interest and whether this means that they end up acquiring the target, having significant influence over the target, selling to a third party or even to the initial offer, will not be predictable. It is only this sort of public buying which is likely to be significant because it will be difficult to disguise or hide behind the types of anonymous schemes discussed above if the amounts involved are at all significant.

If a company does wish to take such a strategic holding in another company, the economic rationale for doing so and for the way that that investment is later dealt with can be assessed in the normal way by the market place. In the end, it will be reflected in the share price of the prospective white knight. Even where the two companies end up with overwhelming shareholdings in each other, such as in the (Washington H.) Soul Pattison and Brickworks structure, the ultimate discipline through the impact of these structures on the cost of capital of the company will be reflected.

The buying that does seem to have occurred under these arrangements has rarely amounted to enough to raise questions of disclosure and whether associations have been established. If the aim of the buying is to create the illusion of a "real" market at a higher share price than otherwise would occur, disclosure under substantial shareholding notices would end the arrangements usefulness. Where the questions do not arise as they do not in virtually all cases as revealed in the earlier report because the holdings do not in aggregate amount to 10%, they are unlikely to be critical in the event of a bid ever being made.

3.4 Placements

Companies have the ability under the Listing Requirements in every 12 month period to make placement of shares or securities convertible into shares equivalent om aggregate to 10% of the then issued capital of the company. This gives the company the ability to place with selected parties substantial parcels of shares which may amount to strategic holdings in the company. Such placements are usually made at some discount to the prevailing market price with discounts in the order of 10% being typical.

Whether such placements can amount to effective protective walls will depend in large part on the nature of the party to which the placement is made.

Where the placee is an institution the holding is likely to be relatively insecure for these purposes. All institutional investors are, in our recent experience, hungry for performance because of the way they are constantly rated and because of the fierce competition amongst them for investment funds. Some of the very large institutions, such as the AMP, are seen as being typically more friendly to existing boards of management than other institutional investors. This different investment philosophy, that is an apparent requirement for a greater premium before the shares are sold in a takeover situation, can at least be partly explained by the different structural constraints on the investment opportunities available to a company or institution such as the AMP which holds such a large amount of funds under management and such a large proportion of the total funds under

management. This size means that they are relatively limited in their flexibility and their ability to place the funds freed through the takeover in new opportunities. The fact that different institutions have different attitudes to investment which results in some being more and some being less willing to sell quickly in takeover situations is no more than an inevitable part of a diverse market place. In itself it cannot be seen as in any way sinister.

Our view is that placements made to institutions at discounts are at least as likely to be destructive to the security of a company's share register as to promote it. A placement at a discount to market made to a small or select number of parties is likely to lead to disillusionment with the company by shareholders if for no other reason than that the value of their investment will have been diluted. As well, the company will have set a price for its shares and this can be later used against it should it seek to defend itself against a bid made even at a small premium to the prevailing market price and placement price. Other shareholders are likely to be annoyed by not having had the opportunity of participating in the placement or protecting themselves against the dilution such as they could if the issue had been done on a renounceable rights basis,

Placements are often made not to institutions but to other parties with whom the company has a strategic business relationship. These companies or entities may also have a higher exit level than typical institutional or general investors because of that strategic relationship. There have been a number of instances where companies have been licensees of particular products or technologies and have sought to secure that relationship by involving the licensor in the shareholding structure of the company. Again, while this may mean that this shareholder would only sell in a takeover situation at a higher level than the general investor might, the fact that there will be a price at which they would sell because of their own economic imperatives has lately been demonstrated. In the recent takeovers of both Speedo Holdings Ltd. and J. Gadsden Australia Ltd. substantial blocks were held by overseas corporations which were commonly classified as being holdings friendly to the existing board. However, in both cases those holdings were sold under the takeover.

That a board may wish to promote such strategic shareholding relationships with its business partners may or may not be simply part of a defensive strategy. It is true, for example, that the relationship now established between Arnotts and Camp bells of the United States has resulted in Arnotts having a large friendly shareholder but it has also opened up opportunities for the products of Arnotts to be marketed into the United States.

Our general experience is that it is very difficult to get parties with such business relationships to take strategic shareholdings by way of placements. It is generally seen as a fairly inefficient way of protecting that aspect of the business relationship which is of key interest to any prospective shareholder. Further, companies with such appropriate business relationships are unlikely to be investment companies. As operating companies they are unlikely to feel comfortable with making any significant investment of funds in a passive shareholding where the expectation would need to be on both sides that it is for all intents and purposes locked in.

Placements may also be effected as part of the consideration for the acquisition of assets. Where such a placement occurs pursuant to a takeover made under the Companies (Acquisition of Shares) Code, the 10% rule described above does not apply.

But the usefulness of a takeover bid for another company as a way of placing stock in friendly hands is limited by the nature of the shareholding structure of any particular prospective target. There have been combinations of companies through takeover which have resulted in large parcels in apparently friendly hands. Thus, it may be argued, public shareholders could have suffered because their company is less vulnerable to takeover. The takeover process is of course a very public event and so any takeover designed for such a purpose is open to wide scrutiny. Any shareholder who disapproves will, we expect, sell quickly.

3.5 Foreign Shareholders

A favoured defensive tactic for a number of years was to place shares with or encourage the purchase on market of shares by foreigners. There will often be business relationships (such as licensor, licensee, supplier, customer, joint venturer, etc) and some companies have sought to use those relationships to convince foreigners to acquire shares. Such shareholdings would generally be identified as being friendly to the Board and so would be included in shares hostile to an unfriendly takeover. The added attraction for the Australian company would be that the Foreign Investment Review Board and regulations under the Foreign Takeovers Act effectively prevented single foreigners from acquiring more than 15% of the shares in the company. This provided added protection against the possibility of the foreigner turning unfriendly.

Recently there have been a number of cases where such foreign shareholders with strategic parcels apparently friendly to the Board did sell under a takeover. As well, with the substantial relaxation of foreign investment restrictions and now even the possibility that all foreign investment restrictions will be lifted, there is the possibility that such strategic shareholdings in foreign hands will be the launching pads themselves for full bids. We have already seen bids made by foreign companies to take out Australian shareholders in, for example, Reckitt & Colman and Nicholas Kiwi Australasia.

There several examples where historically friendly shareholdings held by foreigners have been sold in a takeover situation:

* In J. Gadsden Australia Limited, 10% of the shares were held by Ex-Cell-O Corporation of the United States. In this case, another 20% were held in one parcel being the family shareholding. In the face of a bid by S.A. Brewing (which itself had held 20% as a result of shares which were originally acquired by Carlton & United Breweries because of the major supplier relationship) everyone sold. In many ways this company is a very good example

of the general approach we have taken in relation to the whole question of pre-emptive defensive strategies. Large parcels of shares were, it seemed, locked away in secure friendly hands and the chances of a hostile takeover to succeed seemed slim. Yet, over a few years the circumstances relating to the various shareholders altered and a hostile bid was eventually accepted. The terms of that bid were changed during its course from a partial to a full bid and the price was increased. The bargaining position of the Board of Directors was probably significant in allowing them to extract that better price. In fact, in that case the significant shareholdings were assembled not, we believe, for defensive purposes but rather as an extension of business relationships. If an observer

were looking for a model for a pre-emptive defensive strategy involving placements of shares to foreigners, then Gadsdens could well have been used. But finally, the bid was made and it succeeded.

* In the case of Speedo Holdings Limited, approximately 28% of the shares were held by Warnaco Inc of the United States. That company had become the largest shareholder in Speedo in 1968 and there was a series of marketing arrangements with the company for Speedo's products in the United States. As well, there was a substantial quantity of shares held by members of the families originally associated with the company. There was a change in control in Warnaco and a bid was made for the company in Australia. Warnaco sold its shares.

3.6 Employee Share Plans

For many well known reasons, it is now considered good business for a company to have employee share plans established which will provide additional incentives to employees and hopefully a longer term identification with the earnings and share market performance of the company. This involvement in the ownership of the corporation is also no doubt designed to provide some common interest and identification between the different motives and perspectives of employees and shareholders.

There are various ways that these schemes can be structured and financed. Typically, however, the company will, one way or another, lend money to employees or to a fund at low rates of interest to allow the employee to acquire the shares over some time. The acquisition price will generally be set at some discount to the prevailing market price as is normal in other such stock acquisition plans as dividend reinvestment plans. The shares may be fully paid shares held by the fund or trustee though typically the votes attaching to those shares will not vest with the employee until the shares are fully paid.

Where a company is still significantly influenced by the founder or the group of founders, then it is possible that directors and employees will have very substantial stakes in the company. But in older companies, with a more classical relationship between shareholders and management, it is unlikely that management will have a very large stake in the company. Most of the major industrial and resource companies in Australia that have been in existence for over 20 years fit this sort of pattern. In such a company, it would take a very long time indeed for an employee share plan to be able to accumulate anything like a strategic parcel of even 5%. Some companies with plans that have been in existence for a long time have used the schemes very aggressively such as Lend Lease and there the employees own a substantial stake of the company.

In that instance, the company has proved to be very successful over a long period and is often recognised as being one of the best managed companies in Australia. The identification of interest between employees and shareholders through the employee share plan may well have a great deal to do with this.

If a company were to establish an employee share plan simply for the purpose of trying to collect more shares into friendly hands to be able to resist a takeover then of itself it will not be of much use in the defence of those companies. We know of no instance where a plan that has been established within the previous five years has allowed a substantial enough parcel to be collected to have real strategic significance in the context of a takeover.

Where the shares acquired by the employees pursuant to the employee share plan are held by a trust, then the trustee will have its own responsibilities and duties in the context of a takeover.

Where a company runs its own superannuation fund it may be that this entity could be used to buy shares in the company. This would have defensive implications if together with other share parcels friendly to the board it would be sufficient to build a defensive wall.

Few companies in Australia do run their own superannuation investment portfolio with most being operated by institutional and fund managers. This relationship between the company and the institutional fund manager may itself mean that the fund manager is more reluctant to sell any portfolio investment to a party seen to be hostile to the current board until or unless it were clear that control of the company would change. Such considerations of course would always be subject to the general legal duties of such an institutional fund manager and their performance requirements in the context of the competitive market for managed funds. This sort of factor which may lift the exit price for particular institutional managers as opposed to others in particular situations is just an inevitable part of the complex relationships involved in modern corporations.

Even where the company does run its own superannuation fund, we know of no situation in Australia where such a fund holds a proportion of the company of the kind of levels which has been fairly common in the United States. For example, when Bendix was involved in its series of complex takeovers with Martin Marietta and Allied Corporation, the company's superannuation fund owned in excess of 10% of the company's stock. In that case the trustees were sued by the company when they decided that their duties required them to accept the offer.

Our feeling is that unless a major change in the investment fund industry occurs and there is a major reversion to the practice of companies managing their own superannuation funds, it is unlikely that this source of funds will be of any use in building protective walls. General portfolio management theory would seem to suggest that employees are already exposed to the particular risks associated with the company with which they work so that additional exposure by way of investment of their funds set aside for retirement would be imprudent. Some funds are so large and the company so significant in the Australian market place that it is probably inevitable that some funds will be invested in the company's own shares. Of itself, this presents no problems.

3.7 Share Buy-Backs

There are now a number of proposals and discussion papers concerning the possibility of companies being able to acquire their own stock either through tender offer to all shareholders or through on-market stock repurchase programmes. This has always been available in the United States and has now been adopted in some limited form in the United Kingdom and Canada.

Proponents of the proposal argue that it would give flexibility to the management of companies in relation to their capital structure. It would also allow them to be more aggressive in delivering benefits to their shareholders through both direct and indirect means and possibly in ways that would be more attractive because of tax considerations.

There are already ways in the short term, at least, that would allow a company to have interests in its own shares. The main legislative restrictions on companies financing the purchase of their own shares are at present found in Section 129 and Section 36 of the Companies Code. However, these provisions still allow a company which is associated with another company (a prospective target) and which has its own funding capacity to buy shares in the prospective target company. Equally, the prospective target company itself might acquire another corporate entity which has shares in the prospective target company and the acquirer would then have 12 months to dispose of those shares or otherwise deal with them. That company might be converted into a non-subsidiary so that the shares could therefore remain.

The existing laws themselves allow for shareholders to approve a company financing the purchase of its own stock though that approval is itself subject to application to the courts by interested parties. S.129(10) has not been used as far as we are aware in public companies.

There are a number of structures which have been used by companies or groups of companies to acquire shares to build defensive walls. The Mayne Nickless APM structure involves substantial numbers of shares in each company now being held through structures in which each has some interest. Of course, these structures were established in compliance with the Takeovers Code. They do not represent a direct form of share buy-back but clearly involve a commitment of some shareholders funds one way or another to structures which hold shares in the company itself. Our view is that the association entitlement provisions, as discussed above, are sufficient, even strict, control on establishment of these sorts or structures.

Such schemes are variations on the cross holding strategies discussed earlier. They are subject to the same considerations concerning directors' duties and identification of motives as set out above.

Share buy-backs have been attacked in relation to takeovers where they have been used to effect greenmail. Even there, the history in the United States would seem to indicate that, at best, it buys the incumbent Board some time. Generally, it seems to have taken to show that the company is vulnerable and to have encouraged further takeover attempts.

3.8 Articles Amendments

It is possible for a company to insert into its articles of association (which will generally require a special resolution and

75% majority) provisions requiring majority approvals to partial takeover bids, restrictions on foreign shareholders acquiring more than certain proportions of the company, or articles allowing the directors to refuse to register shares in the event that certain disclosure provisions are not complied with.

Such articles of association certainly increase the number of issues that a prospective acquirer has to deal with when considering its takeover strategy. Whether the difficulty presented by such new articles is likely to be of any significance will of course depend on the particular circumstances of the offeror and the target. It is interesting that of the relatively few companies that have included such provisions, Myer inserted a provision relating to the right of the board not to effect registration of shares in the event of failure to disclose the shareholders identity and ACI has included a provision relating to registration of foreign shareholders.

There are particular issues relating to this sort of defence which are discussed under a separate heading in this study (see Chapter 4, Defensive Strategies and Shareholder Democracy). As well, it may be that the amendments concerning partial bids and the requirement for approval by the majority of shareholders are also a particular case and go to another general issue which we discuss in Chapter 5 concerning the balance of power in takeover situations.

More significant anti-takeover devices such as the very complex poison pill type provisions that are found in the United States where special rights are created to allow shareholders to take up new shares in the event of a bid or which allow conversion at penalty ratios into the shares of the offeror company in the event of an unacceptable bid are probably not generally relevant in Australia. Even in the United States where they have been adopted by a number of companies, they have not proved particularly useful in preventing all cash bids being made. The adoption of such provisions may have hastened the development of different financing techniques to allow offerors to get access to capital to allow them to make all cash 100% bids. But because that form of financing has been well developed and because shareholders seem generally enthusiastic to receive such bids and prevent the company inserting articles which would prevent them happening, they are very rarely adopted.

More potent provisions in the Australian environment would be those which attempt to restrict voting rights in respect of large shareholders or which endow perculiar rights in relation to founder shares or other such classes of securities. The adoption of these provisions by new companies is now restricted by the rules of the stock exchanges. In relation to companies which have such articles, it is probably true that they have imposed constraints on bids being made for the companies, though from time to time, there have been developed technical ways of avoiding their impact and allowing, in effect, all shares to be voted fully.

We are not aware of any recent proposals among Australian companies that such articles might be included. We can think of no reason why shareholders would want to approve such restrictions, although in principle, as our discussion on shareholder democracy indicates, if that were the choice of a 75% majority, we would not see why it ought to be prevented. The context of takeovers because it would impose extra costs (i.e. difficulties) on the offeror, it would have a direct impact on the value of the company shares. That such articles are not conclusive in dissuading an offeror can be seen from those companies (such as AWA) which have attracted bids despite the existence of those articles.

3.9 **Restructuring Businesses**

The company might look to restructure its businesses in ways to create new parties who might acquire shares in the parent or into arrangements which would provide possible penalties in the event of a change of control. For example, a number of companies, in an effort to focus on core businesses and to allow the market to understand better the nature of the risks and potential rewards attaching to those businesses, have moved to place non-core businesses in affiliated and separately listed entities.

We expect that with dividend imputation to be introduced from 1 July 1987, which will allow shares in subsidiary companies to be distributed to the

shareholders of the parent company as a tax free dividend (assuming that the company has paid sufficient primary or compensatory tax), this kind of restructuring will become more common. The recent decision in the South Australian Credit Union Case, seems to mean that shares in such subsidiaries could be distributed or sold to the shareholders in the parent company as of right and which would then allow the subsidiary company to comply with the listing requirements of the AASE without a prospectus. This is, in our view, a very desirable development because it reduces the cost as far as possible of companies distributing to shareholders the benefits new businesses that they have been able to nurture. The parent company may wish to retain a significant stake in the newly separated affiliate.

Several recent examples of companies doing such things are McPherson's Limited, which expanded considerably the operations of what had been its associated New Zealand Company Ajax McPhersons by selling to it all the Australian fastener operations of the company, and Westfield Holdings which separated its share investment activities into a separate company and raised cash by way of rights issue to existing Westfield shareholders. In both these examples, while technically the new companies could be used as part of a defensive strategy, for shareholders there were very direct benefits in terms of the segmenting of different markets and concentration by the companies on core activities.

Other forms of restructuring of businesses could be possible. For example, significant assets might be placed into joint ventures or other arrangements which would mean that in the event of a takeover they would be sold or disposed of. In joint venture or partnership arrangements, venturers or partners will typically be able to withdraw or realize their investment according to some pre-emption arrangement if an unacceptable party acquires control of another party. For the investor this is probably a reasonable precaution but it clearly does have implications for the attractiveness of the company as a takeover target. We have been involved in several instances where there were licence arrangements relating to particularly valuable parts of the business of a prospective target which were determinable in the event of a takeover. In one particular case, the licensor initially announced that the licence would be withdrawn if the takeover were to go ahead. That did not happen, the takeover proceeded after some discussion. This form of restructuring or arrangement of businesses is, again, unlikely to prove conclusive.

In most restructuring of existing operations with which we are familiar, the reasons for doing so are far more pressing immediate financial considerations than a long term defensive strategy.

There have been instances where particular assets or businesses of a company have been acquired or disposed of to friendly parties in return for share issues. This is another way of effecting the kind of restructuring of the shareholding pattern described above in relation to placements. Such transactions will always be subject to the general requirements relating to Directors' duties and there are particular requirements in the listing rules of the AASE where the transactions are effected with a Director or other associate. Section 3J(3) of the AASE Listing Requirements states that where the assets to be disposed of or to be acquired amount to more than a sum equivalent to 5% of the shareholders' funds of the company, the provisions of the rule relating to reports etc must be complied with. While it is true as is often alleged that such reports are of extraordinarily variable

quality and there are organisations who can probably be relied upon to produce a report acceptable to the proponents of the transaction, occasions where shareholders have suffered financial prejudice are, we believe, rare.

3.10 <u>Derivative Securities</u>

Consistent with the rules relating to placements, rights issues and takeovers discussed above, companies may issue to particular parties or generally securities which are neither clearly debt nor equity or derive their value from their relationship to such securities. Options, convertible notes, varieties of preference shares, partly paid shares etc all may be issued by the company to appeal to particular groups of investors or to raise capital for particular purposes.

To the extent such securities gain value from the ability to convert at some stage in the future to ordinary equity or to allow the capital value to be redeemed, this value will be dependent on reasonable expectations as to the future course of the company being predictable. An event in the life of the company which would mean this future direction was liable to be changed dramatically would be possibly destructive to this aspect of the value of these securities and so investors will typically want to be protected against that. Thus, it is a common clause in the terms of the issue of such securities that in the event of a takeover or at the prospect of a change of control, the security holders can exercise their rights of conversion or redemption.

This uncertainty relating to the nature of the balance sheet of a company may mean that for an offeror calculations as to levels necessary to exercise control and amounts of capital required to finance the takeover might dissuade some bids being made.

Over the last 10 years, these kinds of derivative securities have become very popular as the capital markets become more segmented and as investors with particular requirements or preferences are catered for in a more specialised way. It was felt some years ago that there was real advantage in issuing such securities because they did not complicate the balance sheet but this has proved of little lasting value. Offers need only be made to those shareholders who are on the register at a particular time and option holders, for example, who convert under the rights attaching to their options after a bid is announced generally run at least as great a risk of missing out on any benefits to be derived from the takeover.

Takeover offerors have also become adept at using these securities. In a number of instances, they have been aggressively used to appeal

to particular shareholder categories by constructing different forms of securities as part of the offer. For companies which have issued such securities we do not think any particular advantage remains in assisting the defence. Indeed, some offerors have exploited opportunities to expose the company's vulnerability by buying into these securities.

CHAPTER 4

DEFENSIVE STRATEGIES AND SHAREHOLDER DEMOCRACY

A number of the possibly defensive strategies described in the previous chapter involve shareholders being able to vote on the question of whether or not they are adopted or whether or not they approve implementation of certain steps in such strategies. In fact, of the various strategies discussed, some of the most effective in terms of creating barriers to the acquisition of control or regulating how control might pass do involve such approval mechanisms.

For example, there are various proposals for shareholder plebiscite provisions to be included in a company's articles of association which would require an offeror to obtain the approval of more than 50% of the shares other than the shares to which the offeror is entitled before he would be entitled to acquire any shares pursuant to an offer. We believe that so far only one company has put such a proposal to its shareholders and in that case, North Broken Hill, it was approved overwhelmingly by those shareholders which voted. Similarly, restrictions on foreigners acquiring more than certain percentages of shareholdings applicable under the Foreign Investment Review Acts will require approval. It is also worth noting that the proposals in relation to share repurchases by a company all have accepted that shareholders would need to accept and approve such powers to be with the Board or to approve a particular scheme.

The Stock Exchange Listing Requirements also impose certain requirements for approval by shareholders. In particular in this context Section 3J(3) of the Listing Requirements require certain acquisitions and divestitures of assets to related parties to be approved and require the directors to submit reports by independent experts relating to those proposals. Similarly, Section 3E(6) prevents a company from issuing securities of the nature of equity or convertible into equity equivalent to more than 10% of the presently issued equity (except by way of rights issue or through a takeover) except with the approval of shareholders.

In all these cases the legislation, common listing requirements or the common law will require that interested parties do not vote.

The question arises in the context of investigating defensive strategies which may result in shareholders suffering financial prejudice as a result of the adoption of those proposals, whether it is appropriate to impose some restrictions on shareholders being able to adopt such rules.

A number of comments can be made. There is already in the relevant rules and regulations strong resistance to any change in the principle that securities, or at least primary equity securities, (by which we mean fully paid and partly paid shares) should be as far as possible homogenous. Thus, there has been strong resistance to any change in the principle that each share should have one vote. When J. Fairfax Ltd. proposed a class of securities to be listed which seemed to be equivalent in all respects to equities securities except that they were unable to vote except in limited circumstances, the Sydney Stock Exchange refused to accept them for listing.

The same principle has applied traditionally in the United States with the major exchanges, and in particular the New York Stock Exchange, not accepting for listing equity securities with limited or special voting rights. In the United

States as a result of competition amongst the various exchanges, there is now considerable pressure to allow companies the flexibility of introducing securities with variable voting rights and this has now been in principle accepted by even the NYSE.

The principle behind this stand is presumably that investors should be able to rely on an assessment of investment fundamentals when calculating the value of the securities they wish to buy and sell and that investors should not be concerned with having to delve into the fine legal print to see whether or not particular rights apply to particular shares. Investors, it would be argued, should not be concerned whether value is being added or subtracted as a result of such "artificial" considerations.

In fact, we consider that the ability to exercise a vote is generally irrelevant in investment decisions. Certainly, those companies which have a variety of securities, some of which allow voting and some of which do not it is difficult to establish that the margins in the pricing between the securities are explicable by anything other than financial criteria; that is, no value is added or lost merely by reason of the fact that one is able to exercise a vote and one is not. Generally investors are quite disinterested in exercising their rights as to votes. Few shareholders ever do vote, and even in relation to contentious issues, few votes are ever exercised or proxies submitted.

The distinction between the public company situation and other situations such as was found in the recent United Permanent Building Society General Meeting called to consider the possibility of a merger with National Mutual Royal Bank of Canada is apparent. In the United Permanent Building Society situation, all members, which is to say all depositors and borrowers each had one vote whatever the level of their economic interest. In a public company, the level of economic interest, that is the proportion of the total shares, does determine the influence or importance and it may be that this allows companies to quickly identify whether or not a proposal is likely to be acceptable. This may be part of the answer.

However, we believe that there are other stronger reasons as to why votes are rarely exercised. For most shareholders, there are easier and economically more efficient mechanisms available for voicing disapproval or at least disengaging oneself from the relevant constituency when faced with an unpalatable proposal. Clearly, by selling shares, the shareholder can in an anonymous and non-controversial way disengage from the consequences of such a proposal being accepted. As well, for institutional investors, who like to remain anonymous and non-controversial, it will be a decision which is easier to implement because it will be generally

made by the investment manager rather than by the Board of the institution as would be expected if such a high public profile were to be adopted as would go with a decision to vote against the proposal of the company.

It is also true that the Boards of Directors of companies will generally avoid the risk of rejection as far as possible. That is, they will not put up any proposal if it appears that it is unlikely to succeed or if there is a chance that it will generate considerable controversy. Approval margins which would count as landslides in parliamentary elections will generally be simply unacceptable in relation to shareholders meetings. In the instance referred to above where the shareholders of North Broken Hill Ltd. approved the adoption of article amendments in relation to partial takeover bids, while the vote was overwhelming, we believe the debate at the meeting was said to be quite heated and the view of a number of observers was that it would be unlikely that other companies who knew of that experience would try the same thing.

While a shareholder vote or approval would often be useful in getting the views of shareholders in relation to certain actions, a vote will, of itself, not absolve the directors of their own responsibilities and will certainly leave open such legislative protections such as minority oppression actions pursuant to s.320 of the Companies Code.

There are still a number of companies which have voting scales (for example AWA and The Moonie Oil Company Ltd.) even though it is contrary to the Listing Requirements and may even be illegal as a result of Section 124 of the Securities Industries Code which seeks to give those listing requirements the force of law. A particularly interesting situation currently prevails in relation to AWA where Universal Telecasters, a company associated with Mr. Christoper Skase, which launched a takeover bid for AWA, requisitioned a meeting of the company seeking for those articles relating to the voting restrictions to be amended. That vote can be seen in some ways as potentially a referendum in relation to this takeover and it is being promoted as such by the incumbent Board.

Of course many companies are in effect impregnable to takeovers for reasons other than defensive strategies. There is very often a dominant shareholder without whose consent no takeover will ever succeed. Investors buy into such companies with notice that that is the case. In relation to companies listed on the various second boards of the stock exchanges, it is possible that they will have founder shares with special voting rights to effectively ensure continued control in one person's or a small group of peoples hands. In that case, the public policy seems to be that it is better to allow such restrictions in relation to small companies so as to encourage them to get access to the capital markets via the stock exchange than to establish disincentives from doing so by imposing homogeneity in relation to voting shares.

There have been suggestions from time to time that shareholder democracy should be impeded in certain of these matters. For example, in a discussion paper from the Companies and Securities Law Committee in relation to the shareholder choice provisions earlier discussed, it was proposed that shareholders might not be permitted to include such restrictions. That option met with a storm of criticism and of course the ability to include such articles has now received blessing from the legislature.

The principle of shareholder democracy and so the ability of shareholders, within certain limits, to approve placements which might have defensive implications or to agree to the introduction of new articles of association or amendments which impose restrictions on takeovers is at the moment standing firm. Some

might argue that this approach is outdated. Such an argument might be that it is very important to ensure that as few impediments as possible exist in relation to the economically efficient allocation of resources. One of the major ways of ensuring that resources are allocated in the most efficient manner is through the market for corporate control, that is through takeovers. Especially at present in Australia, it might be argued, where there is a desperate need for substantial industry restructuring, it is very important that no such impediments to the reallocation of resources through the market for corporate control should be allowed.

It would be possible to impose on every company listed in the public markets, one set of rules designed to ensure that they were as vulnerable as possible to takeovers, or at the very least that no possible impediments as might be accepted by shareholders through a vote are allowed. But to do so would be setting in concrete rules possibly appropriate for some companies in one period but almost

certainly inappropriate for other companies in other periods. To seek to impose just one model of the relationship between the investors for all time on all companies in the public markets may be just as likely to cause problems at other times as it may be to result in a desirable conclusion now.

The companies listed on the stock exchange or public companies subject to the Takeovers Code are in fact a very diverse collection where the reasons for the assets of those entities being controlled via a publicly held entity with access to the capital markets are extremely varied. Some companies are essentially family concerns who have issued a few shares to raise a bit more capital or to give some members of the family some liquidity. Others are highly speculative investments in resources. Others are coat-tail investments where people in effect give their money into the control of another in the hope that the other person will be able to use their funds to produce above average returns.

Our view is that it is very important to encourage as a wide a range of enterprises as possible to have access to the public capital markets. This means that the flexibility is extremely valuable in relation to the kinds of relationships that are possible between the providers of that capital. To impose homogeneity in relation to the nature of those relationships will restrict access by imposing additional costs at the time the decision is made to have access to those markets. When a company is already listed on the exchange or is a public company, to seek to impose restrictions on how those relationships might be varied or how they might be adapted to new circumstances, would, we believe, destroy potential value, or at least hinder its creation.

Our conclusion is therefore that there should be as few restrictions as possible on shareholders exercising their right to vary the terms of their relationships amongst each other, subject of course to general principles relating to protection against the oppression of minorities. If shareholders do agree to new rules and other investors believe that those rules destroy value then they will not invest. We see no reason to interfere with this market process because if the market does conclude that value is being lost as a result of the new rules and so the assets to be managed subject to those new rules are worth less, then the securities will be valued at less in the market place. This valuation will itself impose discipline on the controllers and where the value loss exceeds the costs of seeking to have the rules changed, then it will be worth someone trying to have them changed.

Indeed, not only do we see no reasons for imposing restrictions on shareholders being able to adopt such measures, we believe that the principle of allowing as many varieties of company with as many

varieties of individual relationships between the providers of capital as possible to be established is good in that it will open up the capital markets to a wider range of companies than if homogeneity were to be forced on all the stock.

CHAPTER 5

DEFENSIVE ACTIONS, SHAREHOLDERS' INTERESTS AND THE BUSINESS JUDGEMENT RULE

Traditionally, it has been seen as inappropriate for a court to interfere with the actions of a Board of Directors where it appears that, on an objective interpretation of the facts, a reasonable person could say that the actions were consistent with the duties of the Directors. There is a presumption that in making a decision relating to the affairs of the company, the Directors have acted in good faith, on an informed basis and in the honest belief that the action taken was in the best interest of the company.

Takeovers clearly put the potential for conflict of interest in the role of the Board and management between pursuing the results which are in shareholders' best interests and results which are in their own self interest in the sharpest relief. It may often seem to be a glib response to the announcement of a takeover that the terms of the proposed offer are "opportunistic, undervalue the company and not in the shareholders' best interests". But at least equally glib is the accusation, almost invariably made privately accompanied by the knowing, world-weary nod, that all that the Directors are interested in is protecting their own jobs.

In Chapter 3 of this paper we discussed a variety of potentially defensive actions which a Board might seek to put in place before a bid became imminent or the terms have been announced. In each case, we noted that there could be a variety of reasons for instituting such moves. While no defensive strategy there identified would be of itself conclusive in preventing a bid, each might in the short term contribute to varying degrees in raising the barriers to a potential offeror. But because each might, on the face of it, be attributable to motives other than purely defensive ones (which for the purposes of this discussion we will assume are not actions consistent with the fiduciary duties of Directors), the business judgement rule would mean that except in the clearest case, the Directors are most unlikely to be found to have breached any duties.

The business judgement rule in effect gives a Board very broad discretions. In the context of pre-emptive defensive strategies, anyone complaining of the actions by the Board will need very good evidence indeed that the actions being contemplated or taken were not in the interests of shareholders. At the moment which is relevant to this study, that is when there is no specific threat but more a general concern about vulnerability to takeover, it is unlikely there will be evidence of a nature of which would satisfy

a court that it ought to conclude shareholders have suffered as a result of their Directors' actions.

But even if it could be established that actions were taken for the dominant purpose of strengthening the defences of a company against a potential takeover, it does not follow that such an action is necessarily contrary to the best interests of shareholders. If a takeover offer is made eventually, then shareholders' interest will be best served if a highest price possible is obtained under the offer.

The price at which the offer is made will depend upon a number of factors. Obviously, the nature of the operations and assets of the company, its productive capacity and earnings and cash flow potential will be one very significant factor. But, in the dynamics of the takeover battle itself, the nature of the shareholding structure of the target company, the proportion of institutional investors, the

potential for competitive bidders emerging, the number of other interested parties who might one way or another significantly influence the outcome - all these characteristics will be important.

If a Board anticipates that a bid might be made for the company and prepares for that with the result that full value for the operating assets of the company is realised in the offer then shareholders' interests will be well served. It will be in their interests to ensure that the company is not sold too cheaply because of deficiencies in the other matters outlined above.

To phrase the issue in this way might be seen as a bit ingenuous. But it is important to realise that the balance of power that exists between an offeror and target company at the time the bid is made is critical to the ultimate success of the bid and the price at which it might be successful.

In our analysis of the various defensive strategies in Chapter 2 and their value over the long term, we alluded to our view that the balance of power as it relates to the various provisions of the Takeovers Code and as it relates to the usefulness of those strategies described changes over time. As the market adapts to and explores the ramifications of the various barriers or restraints imposed by the Code and by the strategies, some prove to be more or less useful in the short term. But over time, none of them seem to be able to prevent the logic of economic benefit being supplanted.

For example, if a company has a widely dispersed shareholding structure with, say, the top 20 holding less than 50% of the shares, no shareholders owning more than 5% and the top 20 comprising almost exclusively institutions, then that company would be, in the ordinary course of events, very vulnerable to a takeover offer made even at a small premium to the market price. Where a coalition of interests among shareholders is established or can be created (everything else being equal), higher prices will typically be necessary for the success of a takeover offer.

The best example in Australia over recent years is perhaps Nicholas Kiwi Ltd. where the various interests of the Nicholas and Ramsay family members were informally allied to encourage an auction situation to develop. Those family interests were not split and the bidders were unable to play them off against each other. That power in their hands meant that the highest price which was likely to be obtained was obtained. The real problem with pro rata partial bids has been that their very structure engendered competition between shareholders because they rewarded the smart shareholder who was able to get benefits at the expense of other shareholders.

This meant that offerors were often able to get control at lower prices than might reasonably have been expected.

If the Board of the hypothetical company with the widely spread shareholding described above were to get a few strategic parcels of shares in the hands of shareholders who might not be expected to sell at just a small premium, they would be altering the shareholding structure of the company to nearer that structure which will be more likely to ensure a higher price is obtained. Such a result would be in the best interests of shareholders. Indeed, the argument only falls down if it can be assumed that the balance of power between offeror and target is evenly balanced in every situation and that the market for corporate control is so efficient that there will always be a potential bidder to bid the price up to the level of marginal economic benefit. That is, if there is any value left which could be extracted from the company's assets and operations above the bid price then another party will always bid. We do not believe that the market for corporate control is that efficient and there is typically a limited number of parties who are liable to bid for a particular company at a particular time.

At present, the business judgement rule presumes that actions of Directors are in the interests of shareholders. Merely because an action might have defensive implications, it cannot be concluded that that was the purpose of the company in establishing it. Even if that were the dominant purpose, then, in the context of takeovers, there are real incentives for Directors to ensure that the balance of power between a potential offeror and the target will result in as high a price as possible being obtained.

This discussion is to some extent outside the terms of reference for this study because actions which merely seek to strengthen the target's hand in the context of a takeover are not the same as building the artificial walls and protective devices designed to prevent any bid at any price being made. Our conclusion in Chapter 2 was that the sorts of strategies discussed do not have that result. Merely because an action may have defensive implications does not mean that it cannot be in shareholders' interests, even if viewed solely within that narrow context.

ATTACHMENT 2

EXTRACT FROM A LETTER DATED 17 JANUARY 1986 WRITTEN BY SEC CHAIRMAN JOHN SHAD TO THE HON. TIMOTHY WIRTH

"...

5) The Commission instructed the staff to prepare for publication a concept release seeking public comment on possible approaches to certain takeover related activities. Specifically, the concept release will address the following topics:

...

* recent developments in the evolution of "poison pills" and whether legislation or regulation in response to those developments is appropriate.

...

7) The Commission also considered a variety of offensive and defensive takeover tactics and issues, and unanimously concluded that the marketplace, and state and federal courts are adequately addressing these issues. The Commission therefore determined not to take or recommend actions that would:

...

d) require that, in partial tender offers, target share-holders he provided the opportunity to vote for or against the tender offer at the same time that they tender their shares (The Commission concluded that partial tender offers do not require special regulations);

e) prohibit or limit "two-tier" or partial tender offers (The Commission noted, among other things, the decline in two-tier offers to two in 1985);

f) prohibit or further regulate anti-takeover charter and by-law amendments (The Commission concluded that full disclosures and shareholder approvals are adequate protections of shareholder interests, and that there is insufficient justification to preempt state law);

g) prohibit the granting of "golden parachutes" (The Commission noted among other things, the changes in taxation of "golden parachutes" and the availability of remedies under state law, and concluded that there is insufficient justification to preempt state law);

h) prohibit "lock-ups" by target companies (The Commission noted among other things, the recent judicial decisions in the Pantry Pride-Revlon and SCM-Hanson contests and concluded that the courts can adequately address lock-ups on a case-by-case basis);

i) prohibit "greenmail" transactions (The Commission concluded that market forces, shareholder litigation, and corporate adoption of anti-greenmail provisions are adequately addressing this issue);