APPENDIX 1

COMPANIES AND SECURITIES LAW REVIEW COMMITTEE

DISCUSSION PAPER NO. 2
PARTIAL TAKEOVER BIDS

MARCH 1985

COMPANIES AND SECURITIES LAW REVIEW COMMITTEE

The Companies and Securities Law Review Committee was established late in 1983 by the Ministerial Council for Companies and Securities pursuant to the inter-governmental agreement between the Commonwealth and the States on 22 December 1978.

The Committee's function is to assist the Ministerial Council by carrying out research into and advising on, law reform in relation to legislation relating to companies and the regulation of the securities industry.

The Committee consists of five part-time members, namely:

Mr. Reginald I. Barrett
Mr. David A. Crawford
Professor Harold A.J. Ford (Chairman)
Mr. Anthony B. Greenwood
Mr. Keith W. Halkerston

The full-time Research Director for the Committee is Mr. John B. Kluver.

The Committee's office is at Level 24, MLC Centre, 19-29 Martin Place, Sydney, New South Wales, 2000.

GENERAL AIMS OF THE COMMITTEE

To develop improvements of substance and form in such parts of companies and securities law as are referred to the Committee by the Ministerial Council and to that purpose to develop proposals for laws:

* which are practical in the field of company law and securities regulation;

* which facilitate, consistently with the public interest, the activities of persons who operate companies, invest in companies or deal with companies and of persons who have dealings in securities; and

* which do not increase regulation beyond the level needed for the proper protection of persons who have dealings with companies or in relation to securities.

In the identification of defects and the development of proposals to have regard to the need for appropriate consultation with interested persons, organisations and governments.

The Reference from the Ministerial Council

The Committee has received a general reference from the Ministerial Council to enquire into and review the question of the appropriateness of the Companies (Acquisition of Shares) Act 1980 as a mechanism for regulating takeovers in Australia.

The Committee has decided to consider first, the matter of partial takeover bids, as these bids appear to provide a focus for some general policy issues and to be the area of main concern in connection with the operation of the present legislation.

Aim of This Discussion Paper

The Committee's aim in preparing this paper is to raise for consideration by interested persons, the issues relating to partial takeover bids where the operation of the present legislation has been suggested to be inadequate, and through provision of an empirical study to provide evidence relevant to discussion of those issues.

The paper is in no sense a draft report. The paper adverts to possible changes in the law at this stage for the limited purpose of stimulating thought on specific issues by persons likely to De interested in the regulation of partial takeover bids.

The Committee has consulted Professor Peter Dodd of the Australian Graduate School of Management at the University of New South Wales, who has undertaken a study of the returns on takeovers, which is contained as an Appendix to this paper.

Invitation for Responses

The Committee invites interested persons to give to the Committee their written response on the issues raised in this paper.

The Committee will assume that it is free to publish any response, either in whole or in part, unless the respondent indicates that the response is confidential. In any event, all respondents will be listed in the Committee's report to the Ministerial Council.

Replies should be sent to: The Research Director, Companies and Securities Law Review Committee, Level 24, MLC Centre, 19-29 Martin Place, Sydney, 2000 by Monday 6th May, 1985.

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COMMITTEE DISCUSSION

PRESENT LAW

The Companies (Acquisition of Shares) Act ("CASA") contains only three rules which distinguish between offers designed to acquire all of a company's voting share capital and only part thereof.

2. The rules specific to the latter ("partial bids") are:

(1) The on market takeover announcement procedure is not a permitted technique (CASA section 17).

(2) An offeror making a partial bid who is already entitled to 20% of the voting capital may not make ordinary market purchases after registration of his Part A Statement (a restriction which however is also imposed on bids for all voting shares if consideration is not cash or certain conditions are attached to the offers) (CASA section 13(3)-(4)).

(3) If the offeror frames his offers so that all offerees may tender all their shares, resulting in a larger volume of shares tendered than that sought by the offeror, acceptances must be pro-rated ("pro-rata offers") (CASA section 26).

3. Thus the salient rules relating to partial bids in the context of general takeover regulation are:

* The bid may be constituted by offers for a specified part of each shareholder's holding, or for all or part of the holdings of each shareholder up to a specified maximum proportion of the capital of the company (CASA section 16).

* The offeror may acquire any voting shares in any manner before service of his formal documentation (Part A Statement) on the target company so long as the entitlement of any person does not exceed 20% as a result (CASA section 11).

* After service of the Part A Statement the offeror may acquire further shares otherwise than pursuant to the terms of the bid but only in the ordinary course of market trading and only until his entitlement or that of another person reaches 20% as a result, (CASA sections 11, 13, and 40).

* The prices paid for, or other terms of acquisition of shares before service of the Part A Statement need not bear any relationship to the price or consideration specified in the takeover offers (CASA section 16), but any price increase given for shares acquired thereafter operates as a variation to the terms of the bid (CASA section 31).

* In the case of pro rata offers the offeror may not elect to keep all or additional shares tendered above the proportion specified in his original offer (CASA section 26).

* The volume of shares tendered must, in the case of listed companies be publicly notified each day as the offeror's "entitlement"· (CASA section 39) If acceptances received exceed the maximum proportion of the share capital that has been sought the offeror will notify an entitlement to a greater proportion of shares than that of which he will ultimately become the beneficial owner after pro-rating.

* If the offers have been open for the prescribed minimum period (presently 14 days) the offeror may withdraw all outstanding offers at any time, and apply the pro-rating procedures only to such shares as have been tendered at the time of withdrawal (CASA section 21).

* If the offer is for a proportion of each offeree's shareholding a shareholder may tender that proportion and sell the balance of his holding; on one view the new shareholder may also tender the specified proportion of the remaindered parcel (CASA section 25).

* In the case of pro rata offers, a shareholder will not know until after close of the offer period what proportion of /: his tendered shares have been taken up; the offer period may moreover be extended initially to six months and even to twelve months (CASA section 27).

CRITICISM OF THE PRESENT RULES

4. On the assumption that the legislative regulation of bids for the whole or part of voting capital of a company has as its principal purpose the achievement of an appropriate balance between the interests of acquirers and those of the general body of target company shareholders where market mechanisms would not be adequate for that purpose, the effect of the present rules has been criticised as being too favourable to acquirers.

5. These criticisms, which are not universally accepted as valid, relate to the principles of equal opportunity and participation in the premium for control, to commercial certainty and investor confidence, and to the effect of the pro rating mechanism. This paper now discusses the criticisms in relation to each principle. It may however be noted at the outset that in the light of the frequent calls for takeover legislation to be observed in accordance with its spirit and intent as well as detailed rules, it would be highly desirable for the fundamental purposes of the legislation to be specified clearly as a guide to interpretation.

(a) Equality of Opportunity and the Control Premium

6. The price margin in a takeover offer over what might otherwise be paid for the shares is described as the control premium. It should also be viewed as a single aggregate amount, in the sense that if it is spread among all shares, the price per share might be reduced from what might be paid in the case of control obtained through acquisition of only some of the shares.

7. A fundamental objective of takeover regulation has been the achievement of equality of opportunity as between shareholders; this is frequently related to the principle that all shareholders should have an equal opportunity to share any premium for control (see for example NCSC Release 101, paragraph 2(iii)).

8. It has been suggested that a partial bid will almost inevitably be a bid for so much of the voting capital as will confer practical control (the obtaining of control being the purpose of a bid); and that since the bid is for less than all capital the bidder is likely to set the price per share at a level that includes the full value to him of that control. (While it does not necessarily follow that the per share premium is likely to be higher for a partial bid than a full bid, it would seem that an offeror making a partial bid must have a competitive advantage over an offeror making a full bid because of the lower financial commitment).

9. Given that control passes upon the success of a partial bid, the value of remaining shares must be reduced, since they will have been stripped of what would otherwise be their proportion of the control premium which is now vested in the control parcel of stock. The incentive to the/controller to acquire other shares and the price he may be prepared to pay will depend on the extent of inconvenience which external holders present to his plans for management of profits and dividends.

10. On this theory it is irrelevant that the fortunes of the company, and thus its share price, may improve under the new management. If the bid is successful the control premium will have passed. If the premium is to be paid on only some shares it is imperative that all shareholders should have equal opportunity to participate in the passage.

11. It has been suggested that the current rules unequally favour the opportunities of large shareholders, who are likely to be approached by an intending offeror who desires to acquire a strategic holding before making a partial bid and who may sell the whole of their shares (often subject to price escalator) without risk of pro-ration.

12. It has been further suggested that a partial bid where pro-rating will apply presents a powerful psychology for acceptance (described by some as "coercion") in that offeree shareholders must compete among themselves. Each accepting shareholder hopes that as many as possible of his co-investors will not accept so that his own returns may be maximised, and no shareholder hoping to maximise current returns can afford to reject the offer. Failure to accept may result in permanent loss by reason of transfer of the control premium otherwise inherent in all voting shares to the shares acquired from those who do tender. One commentator has suggested that "because experience has shown that the after market is usually very poor bidders have learned that they do not need to provide a large premium in the partial offer to generate the stampede of acceptances. In fact the least desirable bidders can pay the lower premiums because the after market of the targets under their control will be weakest". [1]

13. Recommendations from the board of directors or expert advisers not to accept a bid which is less than adequate may moreover disadvantage those who follow such advice, thus placing those whose responsibility it is to advise shareholders in an invidious position. The ordinary advantage enjoyed by the professional investor over the small shareholder is thus magnified in this situation as the former is better placed to determine his course of action in the light of the daily information on flow of acceptances.

14. A related phenomenon of takeover practice in the United States (uncommon but quite practicable in Australia under current law), is the two stage acquisition, where after a successful partial bid a second and lower bid is made for the balance of the capital. A possible variant in Australia might be a three stage bid, in which the highest prices are paid selectively for the first 20% of the shares, followed by bids at successively lower prices. Should such staged bids emerge as a practice in Australia it would conclusively demonstrate the validity of the view of those who suggest that all shareholders should always tender in response to a partial bid made at a premium over current market price.

15. While the selective acquisition of strategic shareholdings below the 20% threshold gives rise to obvious concerns about equality of opportunity, it is not so clear that it is accurate to characterise the incentive to tender in response to a partial bid as in itself a loss of equality of opportunity. That seems to stretch the concept further than the words will easily bear in the context of the present legislation. The principle of equal opportunity at issue here may be expressed as being that the opportunity to participate in the value of any control premium should as far as practicable be proportionally available to all shares (as distinct from shareholders). To uphold such a principle of equal opportunity it is first necessary to assume that a proportional right to corporate control is inherently attached to voting shares (i.e. that control is a corporate asset). Only if it is expressly recognised that a proportional right to the value of control is one of the incidents of a share it is possible to determine what constitutes reasonably equal opportunity to obtain that value.

16. Once the principle of proportional right to any control premium is clear, it can be convincingly argued that the current rules on partial bids may not apply a proper balance between offerors and shareholders, on the grounds that not only does the acquisition of all the holdings of some shareholders before the bid clearly fail to serve the principle of equality of opportunity, but since the value of the control premium may under a pro-rata partial bid be stripped from some shares and accumulated disproportionately in others, what is offered is more a threat than an opportunity.

17. This paper favours recognition of control as a corporate asset. The case for any control premium to be vested proportionately in all shares is based on fundamental notions of fairness and equity: a share is a proportionate interest in the enterprise, and no aggregation of shares ought fairly claim entitlement to a value derived from the enterprise greater than the sum of the individual value of each share.

18. The strongest support for this case comes in the writings of Professor David Bayne S.J. [2] - although he is primarily concerned with sale by a controller - and of Professor William Andrews [3]. The Andrews position was restated by A.B. Greenwood as an NCSC view in a paper to CEDA in March 1982.

19. The case against maintaining such concepts of equity is usually put by economists, who tend to view securities as a market commodity separate from the proportionate interest in the enterprise which they represent. At its highest the argument of the economists runs along these lines - the price of securities will reflect adequately the possibilities of unequal

distribution of gains, and investors who want equal returns can buy government securities or hold diversified portfolios; to attempt to provide more equal distribution of gains will make takeover bids more expensive and therefore less frequent, and this does not assist the welfare of holders of the securities.

20. While having some theoretical appeal, the idea that a "free" market will adequately reflect the possibility of unequal gain is far from proven, and the robust advice to those who cannot stand the heat to stay out of the kitchen is not calculated to foster investor confidence or direct participation in the securities markets by ordinary, i.e. small, investors. The theory that application of a principle of sharing the control premium among all shares will lessen takeover prospects remains unproven: the answer must be that it depends on the circumstances of each case.

21. Ultimately considerations of equity or fairness must have priority over those of mere price efficiency if there were an irreconcilable conflict between the two. In the present case however, the economic argument for price efficiency seems primarily an argument in favour of potential cost savings for bidders. Nevertheless the value judgement concerned is of such importance that the legislature should not leave its resolution in doubt in legislation such as CASA, which necessarily involves a substantial degree of discretionary administration: the time has probably come to confirm one purpose of the legislation as being to ensure that as far as reasonably practicable any premium value for control of a company should be at all times proportionately vested in each voting share.

(b) Other Issues Relating to Equality of Opportunity

22. The principle of equality of opportunity among shareholders would be clearly impugned if takeover offers were withdrawn earlier than the time specified in the offer document and the offeror retains shares tendered. This case may be fairly described as an abuse, and dealt with accordingly by the NCSC using its power to declare conduct unacceptable.

(c) Commercial Certainty and Investor Confidence

23. It is a necessary implication of a pro rata partial bid that shares tendered cannot be taken up by an offeror until the close of the offer period, since it will not be apparent until then what proportion of each tender is to be taken up. Thus shareholders cannot know until that time how many of their shares have been sold, and the matter is further complicated in that the offer period may be extended at the instance of the offeror. In this period shareholders cannot deal with the "balance" of their holdings.

24. Moreover, if the partial bid is unconditional there may be an irreconcilable conflict between the rule that consideration must be paid within 30 days of acceptance (CASA section 16(2) (f) (vii)(A)) and the implications of the rule requiring pro ration of acceptances (CASA section 26) as this can only occur after close of the offer period.

25. Technical problems may also arise on pro ration in connection with odd lots, particularly for institutional nominee companies which hold shares for multiple separate accounts.

26. The whole process of pro-ration as an appropriate policy is called in question below. In the event that pro-rated offers remain permissible under the legislation, the possibilities of extension of the offer period, conflict over due date for consideration, and the position of nominee companies, clearly detract from certainty and confidence; although not common occurrences each attracts the need for specific amendment.

OVERSEAS APPROACHES TO PARTIAL BIDS

27. The contrasting approaches to partial bids adopted in the United Kingdom and North America shortly encapsulate the polarities of viewpoint on the subject of partial bids and the essentially political policy choice which must be made.

28. Under the City Code on Takeovers and Mergers which regulates takeover bids for public companies "resident" in the United Kingdom:

* No partial offers may be made without consent of the Panel, but this is usually given if the offeror would emerge with less than 30% of voting capital. (The consent is forthcoming because the basic bid threshold under the City Code is 30%.)

* Restraint is placed on share purchases by the offeror or persons acting in concert both during the offer period and for a period of 12 months after and, if the offeror would hold more than 30% of voting capital after the offer, consent will not normally be granted if shares have been acquired selectively or in significant numbers during the preceding 12 months.

* Where the offeror's eventual holding would be more than 30%, the offer must be conditional upon separate approval being given by shareholders, independent of the offeror, who hold over 50% of the voting rights.

* Where the eventual holding would be between 30-50%, the offer may not be declared unconditional as to acceptances unless acceptances are received for at least the desired number of shares.

* Where there is more than one class of equity capital and the offeror would ultimately hold more than 30% of one class, comparable offers must be made for each class.

* Where the offeror's holding would exceed 50% of the target's capital at the close of the offer, the offer documents must state that, if the offer is successful, control will pass to the offeror who will be free to exercise that control and acquire further shares without incurring Obligations under the code.

* Pro rating provisions apply.

29. In the United States of America and Canada partial bids are, as in Australia, subject to few specific rules additional to those applicable to any takeover scheme. In the United States of America the subject has been recently examined by the SEC Advisory Committee on Tender Offers (Report dated 8 July 1983), and since its report is one of the few official documents to discuss policy issues and principles, and the relevant section is succinct, it is quoted in full:

"B. Partial Offers and Two-Tier Bids

Current regulations under the Williams Act make little distinction between full offers and partial offers. The relatively recent phenomenon of the two-tier or front-end loaded bid likewise has not been subject to different regulation. The Committee considered at length whether partial offers and/or two-tier bids should be distinguished under the regulations from offers to purchase all shares, and, if so, whether the partial offer and/or the two-tier bid should be prohibited or simply disadvantaged under the regulations.

There is substantial sentiment on the Committee that, so long as there is equal opportunity for all shareholders to participate in all phases of each bid, the laws should not distinguish among various types of bids. Those favouring no change in the current system argue that the preservation of partial tender offers is important to the working of the economy and that there are many valuable roles for partial offers and partial ownership, including

(1) allowing companies to invest in one or more industries with more limited financial exposure than if the ownership were 100%;

(2) facilitating technology exchange relationships;

(3) permitting change of control and reducing management entrenchment in large companies;

(4) facilitating private direct investment, such as venture capital;

(5) acknowledging the common practices of suppliers of foreign capital in the United States; and

(6) allowing acquirors to get to know a potential acquiree over time with a view to moving to 100% ownership.

These members posit that if partial bids therefore are permitted, two-tier bids should not be precluded, since as a practical matter such bids are more favourable to target company shareholders than partial offers with no second step. In such two-tier bids, a second step at a lower price than the first step normally is at a premium to the unaffected secondary market absent any second step.

The majority of the Committee, however, did not believe that the reasons advanced for equal treatment of full, partial and two-tier bids completely outweighed a concern with respect to coercive elements of partial and two-tier bids and the potential such bids provide for abusive tactics and practices. While some would have prohibited such bids altogether, the Committee determined to recommend a regulatory disincentive for partial offers and two tier bids. Such disincentive would be provided by requiring a longer minimum offering period for partial bids than that required for full bids.

Recommendation 16

The minimum offering period for a tender offer for less than all the outstanding shares of a class of voting securities should be approximately two weeks longer than that prescribed for other tender offers.

The Committee gave considerable thought to adoption of requirements similar to those provided in the British City Code on Takeovers and Mergers, i.e. restrictions on open market purchases above 15% and the general obligation to make an offer for all shares if the amount owned or sought exceeds 30% of the outstanding shares. Adoption of such a system in effect would preclude a number of significant partial offers and generally would require share purchases above a defined amount to be accomplished through a tender offer for all Shares - for cash or securities or a mix thereof - at the same or different values. An essential corollary would be the elimination of supermajority and fair value charter provisions, and the adoption of a 'non-frustration' doctrine to govern the actions of target management. While the British system has considerable attractions, the Committee determined that a more evolutionary development was appropriate, particularly in view of its conclusions concerning partial offers. In the event that the recommendations of the Committee do not have the desired effects, however, the Committee suggests that the

Commission reconsider incorporation of some features of the British System.

OPTIONS FOR REFORM

30. The purpose of regulation of partial bids must primarily be to remedy market imperfections in the interests of shareholders; claims for incumbent controllers, at least in the case of companies listed on the main boards of stock exchanges, for a right to stability of the share register should be treated with some scepticism. Defects which have been identified must be balanced against the opportunities provided by such bids and the benefits flowing from partial bids as identified by the SEC Advisory Committee should be given full weight. The choices (other than no action or further movement towards unrestricted market operation) appear to be:

(a) Restriction on Partial Bids Generally

31. If the imperfections of the mechanism for a partial bid are thought to outweigh the opportunities it presents for additional investment opportunities for shareholders, then provisions along the general lines of the City Code on Takeovers and Mergers might be introduced into the Companies (Acquisition of Shares Act to the extent these do not already form part of the legislative framework.

32. Since a cornerstone of that form of regulation is that regulatory consent is required for partial bids above the threshold, one issue in the Australian context is whether, if this option were to be favoured, this form of regulation should include the vesting of a specific consent discretion in the NCSC, and if so whether the legislation should include guidelines for grant of such consent along the lines of those which appear on the face of the City Code together with any additional matters. The alternative would be to prohibit partial bids except in specified circumstances, (i.e. those where the City Code requirement would be satisfied) but subject to the general exemptive powers of the NCSC expressed in sections 57-59 of the legislation.

33. A purely discretionary approach in the Australian system must be seen as unattractive - involving as it would a merit judgement on the fairness of each individual bid. It is nevertheless plain that the operation of the threshold may confer an opportunity advantage on some shareholders by affording them an exemption from the pro-rating provisions. There is a conflict between the principle that acquisitions not giving rise to control should not be regulated and the principle of equal opportunity in relation to pro-rated acquisitions. This conflict can only be completely resolved by reducing the threshold to 0% in the case of partial bids. A compromise position might involve adopting the City Code rules prohibiting a partial bid within a specified period after significant acquisition, and follow up bids. A more direct and ultimately simpler approach would be a substantial, but not absolute, reduction in the threshold. Such provisions may be supported bearing in mind that in the Australian context the NCSC would retain an exempting power in respect of these restrictions as with all others in the legislation, to be exercised in accordance with the guiding principles of the Code.

34. The Committee has furnished a separate Report to the Ministerial Council on the Takeover Threshold. In the course of preparation of that Report views were sought as to whether the threshold for partial bids should be reduced to say, 15% or 10%. A substantial majority of respondents disagreed with this proposition, but the matter deserves further consideration. A downward adjustment of the threshold would not only enhance equality of opportunity in relation to holdings acquired but could also contribute to the amelioration of some of the coercive effect that is associated with a bid for control to be acquired through only some shares, because a lower starting point could affect the bargaining power of the offeror to a quite significant degree by facilitating the emergence of competitive offers.

35. The most significant feature of the provisions of the London Code is that where the offeror's eventual holding would be more than 30% an offer must be conditional upon approval being given by shareholders, independent of the offeror, who hold over 50% of the voting rights. In other jurisdictions provisions to this effect have been inserted in the articles of association of potential target companies, and have become known as "shark repellants". Proponents of such a requirement for approval (including many in Australia), whether given at a meeting of shareholders or by some form of plebiscite in the course of a bid, frequently suggest that it is a "free market solution", but such a hypothesis begs almost as many questions as it answers.

36. In a recent article [4] Leo Herzel and John R. Schmidt suggest two possible reasons in favour of a requirement for shareholder approval:

* it would enhance the directors' bargaining power in connection with any potential sale of the enterprise; and

* corporate management would be improved by eliminating the possible threat of hostile takeover through being able to undertake longer term planning, the beneficial effects of which cannot be directly measured in economic terms.

(A further possible rationale suggested by a Study of the Office of Chief Economist of the Securities and Exchange Commission [5] (the "SEC Study") is that management will try to protect its job in one way or another, and such amendments will benefit shareholders because they will discourage other, more costly, maneouvres.) The authors of the article suggest that if the advocates of the benefits of unrestrained hostile takeover bids are correct, shareholders would never vote for such provisions (to be inserted in the articles of association) of if they did the value of their shares would be adversely affected. A similar argument would of course apply to the approval of the bid itself - shareholders would never refuse. In either case it is implied that there can be no harm in giving shareholders the option.

37. The most persuasive argument in favour of a requirement for shareholder approval of a bid is however one noted by the SEC Study. The SEC Study suggests that if it be assumed that a takeover will result in a sharing of wealth between offeror and

target company shareholders, the position of the latter is stronger the more cohesive they are in determining their response, and a requirement for approval can force shareholders to act in a more cohesive manner. Where they know a bid will only be successful if a specified majority of shareholders accept the offer, they have less to fear by not tendering to any offer which they think is too low. Presumably the fail-safe procedure is to accept the bid but vote against it - but this may require a level of sophistication beyond what may be expected of the ordinary voter.

38. However, observation of recent Australian experience of approval proposals presented to shareholders meetings, including meetings which have considered acquisitions, pursuant to paragraph 12(g) of the legislation, does little to inspire confidence in the route of shareholder ratification as a valid means of expression of informed shareholder will. It must be recognised that it is difficult to provide adequate disclosure for such purposes, particularly as disclosure has obvious psychological limits in this area. Directors whose motives are improper, i.e. if they are more concerned with preserving their incumbency than acting in the best interests of the shareholders as a whole body of investors, are unlikely to disclose to a meeting the unfairness of their behaviour.

39. In the USA any proposal to insert a restrictive amendment of this kind into a company's articles must be accompanied by proxy materials which:

* explain the reasons for the shark repellants and the bases of the reasons including the factors and/or

* principles supporting or serving as a foundation for the reason stated;

* whether the proposal is the result of management knowledge of a specific effort to take over the company (and if not, why the measure is being proposed);

* describe the overall effect of the amendment;

* discuss its advantages and disadvantages for both management and shareholders.

Such disclosure should be also regarded as the absolute minimum for shareholder adoption of any such scheme in Australia. In 1979 the SEC warned that shark repellant amendments appeared to be inconsistent with the protection of investors and the congressional purpose underlying the Williams Act. However, the SEC Advisory Committee on Tender Offers in its Report recommended only that such shark repellants be approved periodically, i.e. at least once every three years. More recently the SEC Study has established empirical evidence that charter amendments lower the stock price of the company.

40. The fundamental objections to the inclusion in the articles of association of a provision requiring a vote of shareholders for approval of a particular takeover, whether or not it is periodically reaffirmed at a shareholders meeting, are firstly that it is inconsistent with the principle that a share in a public company should be transferable without consent of other

shareholders and secondly that because the reasonable shareholder must diversify his investments as a means of spreading risk, he frequently lacks a sufficient financial interest in any particular company to have an incentive to determine whether the proposal is appropriate. Both the cost of a meeting and the incumbents control of the proxy process render an outcome rejecting such proposals unlikely. As the SEC Study notes, there are two hypotheses which make success of such resolutions likely. One possibility is that there is a group of shareholders (institutions) which gains by working with incumbent managers. These shareholders may have a deciding balance of voting power. The second possibility is that ordinary shareholders have relatively high information costs in determining the impact of the resolution on their wealth. They may find that in general their wealth is maximised by agreeing will the resolutions proposed by the incumbent board rather than expending resources to predict the effects themselves.

41. A legislative requirement for shareholder approval to a partial bid along the lines of that required by the City Code would of course go much further than the "free market" hypothesis which has been advanced to justify the insertion of such provisions into the articles of companies. While the free market hypothesis itself suffers from the defect that it penalises shareholders who not unreasonably fail to anticipate a subsequent failure of the board of directors to fully discharge their fiduciary obligations, the incorporation of such a requirement in the legislation would signal a significant policy bias against partial bids. That bias is not supportable upon the economic evidence provided in the Appendix of this Discussion Paper as being in the interests of investors generally.

42. A vote on approval of a specific bid suffers similarly from a bias in favour of the incumbent board. If the target company board opposes the bid, stating that the shares are worth more, the voting mechanism must for the reasons outlined above strongly favour an outcome rejecting the bid. Where the specified requisite majority is absolute, shareholder apathy also works for incumbent control in this context. A shareholder approval requirement may thus be merely a tactic giving only the illusion of freedom and fairness which diverts attention from the main issues - the economic benefits of the takeover, the equality of opportunity: for all shares to participate in the control premium, and managerial self-interest. There is also something curious in a suggested "free" vote in which the associates of one side of the case are forbidden from voting, while the other side is free to rally as much opposition as it can in any manner it wishes. Finally, the argument for a free vote of shareholders assumes that the vote is based on knowledge, but current experience is that adequate disclosure for these forms of decision is the exception rather than the rule. It also has to be assumed that approval in fact provides an accurate reflection of shareholder wishes: an assumption which in the light of the normal proxy gathering and meeting process or in the case of a plebiscite, response process, must in many cases be unfounded.

43. It may be concluded that not only should there not be legislative provision restricting the making of a partial bid to instances where there is shareholder ratification of the bid, but in the case of companies admitted to listing on the main boards of stock exchanges there should be a positive requirement prohibiting the incorporation of such "shark repellant" provisions into the articles of association.

44. In the light of the foregoing discussion, a matter of even greater concern is the suggestion of defences of a kind similar to those known in the USA as "poison pills". These defences provide, in one form or another, for the potential issue of new share capital on terms that discriminate between the interests of a bidder in the event of an unwelcome bid. Such provisions are obviously an abuse: the capital issue has nothing whatever to do with the company's need for additional equity funds, and may have little to do with the economic interests of shareholders as a whole.

45. Such tactics by incumbent controllers should be sharply discouraged. To this end, the legislation should enable a member of the company to apply to the Court for the avoidance of any issue of share capital where the allotment is in its terms consequential upon the acquisition or proposed acquisition by any person of a substantial interest in the company unless it is shown that the allotment is in the interests of the members of the company as a whole. While this solution would depend on litigation of a difficult issue - "interests of the members of the company as a whole" - for its effectiveness, the onus on the board/company to justify the issue could act as some deterrent against the more blatant cases.

(b) Restriction of Partial Bids to Proportional Bids

46. Many of the criticisms of partial bids arise directly or indirectly in relation to the effects of pro-rating, since it is this element that supplies the coercive engine. The fewer shareholders that accept, the more likely it is that all

benefits will flow to those who do. Even though few offers in Australia have resulted in pro-rating, it is the threat of pro-ration which is coercive. Such coercion is not such a significant element in a partial bid made for a specified proportion of each shareholding because failure to tender does not inevitably imply a corresponding increment in the value to be received by shareholders who do tender. The arguments in favour of partial bids summarised in USA Advisory Committee Report (above) would in the main still be satisfied in the case of a proportional partial bid.

47. The case for a reform limiting partial bids to proportional bids has been argued at length by Dick Gross. [6] The logic and simplicity of such a requirement in meeting the various criticisms is strong especially when shareholder plebiscite proposals are rejected. On the other hand it may be thought that such a limitation could probably make a partial bid impracticable for an offeror who is aiming at a specific percentage holding in a company, such as 50.1%, since the leakage in acceptances would produce too great a margin of uncertainty in framing the bid. There is no doubt that under such a regime offerors would have to allow a margin over the minimum target (which could be underwritten by a minimum acceptance condition). Should the offer be more successful than desired, the offeror could dispose of the excess holding after close of the bid.

(c) Application of a Special Time Disincentive to Partial Bids

48. The solution of extended time as proposed by the USA Advisory Committee seems unlikely to resolve the criticisms of partial bids in an Australian context. The extended period could even add to market uncertainty and detract from investor confidence in Australian Markets.

49. A different form of time regulation of partial bids is prescribed under Ontario Law, under which the maximum time period for a partial bid is 35 days and the pro-ration and payment must be completed within 14 days of the close of the offer period; in a total bid, by way of contrast, while acceptances received at the end of the first 35 days must either be taken up or abandoned, there is no maximum time limit for the offer period.

50. If the proposal to eliminate pro-rata partial bids is not adopted, a short maximum period for a partial bid, e.g. one month, would at least enable many of the uncertainties relating to success and payment currently inherent in the pro-rata mechanism to be resolved within a reasonable time and may be supported accordingly.

SUMMARY AND CONCLUSION

51. This discussion paper has suggested that partial bids, while presenting shareholders with particular difficulties, also may be beneficial to investors. They should therefore not be subjected to further substantial restrictions beyond those consistent with securing reasonably equal opportunity for shareholders and directors to consider the bid and participate in those benefits without coercion.

52. The Committee seeks reactions to the question whether there should be adjustments to the legislation along the following lines:

(1) there be included in the legislation a clear statement of the basic objectives that it seeks to achieve, being the principles stated in sections 59 and 60, amplified by a further principle that as far as reasonably practicable the value of any premium for control should be at all times proportionately vested in each voting share;

(2) a partial bid be capable of being made only for a specified proportion of each shareholder holding;

(3) a partial bid not be permitted in the case where a person who is already entitled to 10% of the company's voting shares would increase his entitlement to more than 20% as a result of the bid;

(4) if the second suggestion above is not adopted, the maximum offer period for a partial bid should be one month with a consequential prescription of the time within which the consideration for a partial bid should be paid, and this period should not be capable of being extended;

(5) any provisions in the constituent documents of a company listed on the main board of a stock exchange limiting the right to acquisition of shares pursuant to a partial bid made in accordance with the legislation be declared ineffective;

(6) a member of a company be enabled to apply to the Court for an order that the allotment of any share capital be avoided where the issue is related to the acquisition by any person of a substantial interest in the company unless the company shows that the issue was in the interests of the members of the company as a whole.

53. If any adjustment to the present law is deemed desirable, the Committee believes that the necessary legislation should be introduced as soon as practicable, and proposes to so recommend to the Ministerial Council for Companies and Securities.

FOOTNOTES

1. A.R. Berg as quoted in BRW 15-21 October 1983

2. See for example The Sale of Control Premium: The Intrinsic Illegitimacy Texas Law Review Volume 47 (1969) 215.

3. The Stockholders Right to Equal Opportunity in the Sale of shares (1965) 78 Harvard Law Review 505.

4. "Is There Anything Wrong With Hostile Tender Offers": Corporation Law Review Volume 6 No. 4 (1983) 329.

5. Shark Repellants: The Role and Impact of Anti-takeover Charter Amendments. Study of the Office of the Chief Economist of the SEC, September 7, 1984. CCH Federal Securities Reporter 83,714.

6. Partial Takeovers - A Critique (1983) Company and Securities Law Journal Vol. 1 No. 5 251.

APPENDIX

The Returns to Offeree Shareholders in Partial and Full Takeover Offers

by

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AGSM

1. INTRODUCTION

This study has been prepared at the request of the Companies and Securities Law Review Committee (CSLRC). The objective is to empirically assess the effect of takeover bids on offeree company shareholders. In particular the study focuses on partial takeover offers and provides evidence on the investment returns earned by offeree shareholders in partial offers both in absolute terms and relative to those earned in full takeover offers.

The outline of the paper is as follows. The next section describes the data used in the study and section 3 discusses the methodology used to analyse that data. Section 4 presents the results and the final section discusses the implications and conclusions of the study.

2. THE DATA

Given the cost and time constraints imposed by the CSLRC, it was agreed at the outset that the study be limited to takeover offers in the two financial years 1981/82 and 1982/83. While there is no reason to believe this time period is in any way abnormal, it must be noted that 2 years is a relatively short sample period and generalisations based upon this sample data must be tempered accordingly.

Appendix

2.

The primary source of the data is the list of takeover offers collected and published by the Sydney Stock Exchange (SSE). This list appears to be the exhaustive set of offers made for companies listed on the SSE in the period July 1981 through June 1983. Restriction of the sample to firms listed in Sydney is not believed to impose any bias on the analysis. From this list and the company files at the SSE the following details of each offer were collected.

* Names of offeror and offeree companies
* Date of public announcement of the offer
* Number of shares sought in the offer
* Number of shares held prior to the offer
* Offer price
* Closing date of the offer
* Any revisions of the offer including price and closing date
* Outcome of the offer in terms of the number of offeree shares that were purchased in the offer.

Where these details could not be found in the SSE, they were collected from the company secretary of one of the firms involved.

The offers in the sample are classified as either full or partial offers. A full offer is defined in this study as an offer to acquire 100% of the outstanding shares of an offeree or target company. A partial offer is any offer for less than 100% of outstanding shares.

In a number of cases the initial offer is revised with a new offer price and closing date. For the purposes of this study, any such revision is treated as part of the initial offer and the duration of the offer is measured from the initial announcement through the final closing date of the ultimate offer made to shareholders. Similarly there are cases where a different offeror company makes a competing bid. Where the competing bid is announced before the closing date of the initial bid the duration of the offer is measured from the initial announcement through the closing date of the ultimate offer made to shareholders. The offer price is deemed to be that of the final offer.

To calculate the returns earned by shareholders, daily closing share prices have been collected from the Daily Official List of the SSE. Dividends and capital changes were collected from the files of the Centre for Research in Finance. Where an offeree company did not have traded prices around the relevant dates (see below) of the offer, it was not included in the analysis[1]. In cases Where the offer price was in terms of shares in the company, share prices were collected from the same source.

The descriptive details of the sample are summarised in Table 1.

1. Note that a company can be included in one part of the analysis but excluded from another when closing stock prices for that company are available at some relevant dates but not others. Hence the number of firms used in different parts of the analysis can vary.

3. THE METHODOLOGY

The essence of the methodology utilised in this study is to design the set of relevant investment strategies available to a rational shareholder facing a takeover offer. The returns to these strategies are then estimated and analysed.

The notion of alternative investment strategies is important. The mechanics of takeover offers are such that shareholders are faced with a process in which the uncertainty of the offer outcome is eliminated over a period of time. The process begins with the first public announcement of the offer. After this initial announcement there is uncertainty as to how the offer will conclude and a variety of outcomes are possible. For instance the bid can be revised and/or a competing offer emerge. On the other hand the offer may be withdrawn. In general, after the announcement of the offer, target shareholders are uncertain as to its final outcome. However, the existence of a well functioning stock market enables these shareholders to avoid the uncertainty of the offer outcome by selling in the market to investors willing to bear that uncertainty. In evaluating the returns earned by shareholders in takeover offers it is crucial to consider all the relevant investment strategies including selling shares in the stock market during the offer. Furthermore, it is essential to consider the different outcomes that are possible. For example, inclusion of only successful offers invokes a sample selection bias that seriously restricts the valid inferences that can be drawn from the study.

Since there are numerous possible outcomes to any offer and since the period from initial announcement through final resolution can encompass several months, there are endless investment strategies that can be implemented. As is shown below, in this study the strategies are limited to a small set of consistent investment decisions focused on the initial announcement and final outcome resolution dates.

Where there are no competing offers or any revisions to the original offer, the broad strategies available to a target shareholder are to:

1. accept the offer and tender all shares at the closing date

2. sell all shares in the stock market after the initial announcement and before the closing date

3. hold the shares, i.e., neither accept the offer nor sell in the market.

Where there is a competing offer (i.e., an offer from a different bidder announced before the first offer has closed) or the initial offer is revised, the offer process is more complex. For the purposes of this study it is assumed that, from the offeree shareholder perspective, the effective closing date is the closing date of the highest offer that is not withdrawn. It is possible that some shareholders will accept an offer before its closing date and thereby forego the possibility of receiving a higher competing bid. This would not appear to be a rational strategy and is ignored in the analysis below.

The broad strategies and the alternative outcomes are diagrammed in Figure 1 and discussed in more detail below. To calculate the returns to the alternative investment strategies the following definitions are used:

P = offer price of the final offer

PB = share price before the first public announcement of the offer, defined as the closing price 20 days prior to the initial offer announcement[2]

PC = share price at the closing date

~ = shares acquired in the offer as a percentage of shares accepted, i.e., the prorata percentage when the bidder does not acquire all shares tendered

PA = share price immediately after the initial offer announcement

d = dividend paid during the offer.

The specific investment strategies considered in this study are defined below.

2. The analysis below was replicated using a share price 40 days before the offer and while some differences were observed the general implications and conclusion are unchanged.

Appendix

A. Full Takeover Offers

Strategy 1: Accept the offer and tender all shares to the bidder and

(a) all tendered shares are acquired in the offer.

The return to shareholders is defined as:

$$R = \frac{P - PB + d}{PB}$$

(b) all shares are returned by the bidder:

$$R = \frac{PC - PB + d}{PB}$$

Strategy 2: Sell in the market

(a) immediately after the offer is announced

$$R = \frac{PA - PB + d}{PB}$$

(b) at closing date

$$R = \frac{PC - PB + d}{PB}$$

B. Partial Takeover Offers

Strategy 3: accept the offer, tender all shares and

(a) all tendered shares are acquired in the offer:

$$R = \frac{P-PB+d}{PB}$$

(b) bidder prorates the offer and a proportion of tendered shares are acquired in the offer and the reminder are returned:

$$R = \frac{[\sim P+(1-\sim).PC]-PB=d}{PB}$$

(c) all shares are returned by the bidder:

$$R = \frac{PC - PB + d}{PB}$$

Strategy 4: Sell in the market

(a) immediately after the offer is announced:

$$R = \frac{PA- PB + d}{PB}$$

(b) at closing date

$$R = \frac{PC - PB + d}{PB}$$

Strategy 5: the offer is not accepted, all shares are retained and the offeror proceeds to acquire shares tendered by other shareholders i.e., the offeree shareholder foregoes opportunity to sell shares to offeror.

$$R = \frac{PC - PB + d}{PB}$$

4. RESULTS

The results of the analysis are presented in Table 2 which shows the returns to investors following the different strategies outlined above and in Table 3 which present the premiums by sup periods.

In terms of the more general strategies, shareholders accepting all full takeover offers and tendering their shares to the offeror earned average returns of 38.3 percent. Shareholders following the same strategy in partial offers earned average returns of 27.3 percent. As can be seen in Table 2 the returns earned vary across the different outcomes (the outcomes are defined by the prorata score which indicates the proportion of shares purchased by the offeror).

Assuming the samples of full and partial takeovers are independent, the difference between the average return to accepting a full offer and the average return to accepting a partial offer is not statistically significant (t statistic of 1.3).

Where an offeree shareholder followed the strategy of selling shares in the stock market after the initial announcement of the offer (and thereby avoiding the uncertainty of the offer outcome), the average return was 20.6 percent in full offers and 17.0 percent in partial offers and again the difference is not statistically significant.

While it is true that the lowest returns (mean of 7.5 percent) are earned by shareholders in partial offers where the offeror prorates the acceptance and returns some shares, this is only one possible outcome of the partial offers.

When all the possible outcomes are considered it seems that offeree shareholders in partial offers are not differentiated. In only a very few cases are offeree shareholders worse off after the offer than before.

Furthermore, when the returns from the various strategies are compared to those earned by investors in the stock market in general, it is clear that offeree shareholders do remarkably well. This analysis is presented in Table 2 as the Mean Market Adjusted Return. It is calculated by comparing the return to each strategy with the return earned on the market as a whole (taken from the files of the Centre for Research in Finance) over the duration of each offer. As can be seen in Table 2 offeree shareholders substantially outperform the market in all strategies for both full and partial offers.

5. CONCLUSION

This study presents evidence on the investment returns earned by offeree shareholders in takeover offers. The results indicate that on average, these shareholders make substantial gains from both full and partial offers. Furthermore, although the average return is generally smaller in partial offers than full, the difference is slight and not statistically significant.

Appendix

TABLE 1

Summary Description of the Sample of Takeover Offers

Announcement Date	Full	Partial
7/1981-6/82	68	16
7/1982-6/83	50	10
Total	118	26
Mean Market Capitalisation:	24.3m	43.4m

No. of Competing bids	15
No. of Revised bids	28
Consideration offered:	
Cash	125
Stock	19

TABLE 2

RETURNS TO OFFEREE SHAREHOLDERS IN TAKEOVERS

	No. of Firms	Mean No. of days in Strategy	Returns					Mean Market Adjusted Return
			Mean	Median	High	Low	% + ve	
FULL OFFERS								
Strategy 1: Accept offer								
(a) prorata = 1.0	70	92	40.2	36.3	157.9	-42.9	94.3	39.1
(b) prorata = 0.0	8	90	19.9	11.1	57.1	-13.3	75.0	18.0
Total	92	38.3						36.9
Strategy 2: Sell								
(a) at announcement	66	20	20.6	18.3	104.0	-33.3	86.4	20.4
(b) at closing	55	88	32.5	25.0	152.6	-26.7	87.5	29.3
PARTIAL OFFERS								
Strategy 3: Accept offer								
(a) prorata = 1.0	5	86	32.8	16.3	87.3	12.1	100.0	40.6
(b) 0 < prorata < 1.0	6	77	7.5	12.8	24.6	-3.9	67.0	12.0
(c) prorata = 0	10	88	36.4	43.2	112.5	-4.8	90.0	30.9
Total	21	84	27.3					27.8
Strategy 4: Sell								
(a) at announcement	18	20	17.0	11.7	125.0	-13.1	94.4	17.4
(b) at closing	19	86	18.1	10.6	112.5	-28.0	73.7	17.4
Strategy 5: Hold and prorata ≠ 0	9	84	-2.2	0.0	36.4	-28.0	55.5	2.5

Appendix

TABLE 3

Premiums in Partial Bids

Period	Mean %	Std. Deviation	No.
July - Dec 81	16.8	7.0	4
Jan - Jun 82	31.9	29.1	8
July - Dec 82	23.7	10.2	5
Jan - Jun 83	30.3	19.7	4
Overall	26.8	20.4	21