CHAPTER 2

THE MANDATORY BID RULE

The MBR as a policy instrument

2.1 The proposal for the introduction of the MBR was developed within the framework of the Government's Corporate Law Economic Reform Program (CLERP) which brought an economic focus to the Corporations Law. As stated by Treasury the fundamental objectives of the Law are to facilitate investment, employment and wealth creation.[1] A key area of the Law identified for review and reform was the regulation of takeovers. According to the Treasury paper on Takeovers, the basic objective of takeover regulation is to improve market efficiency. "All regulation involves some costs," the paper added, "and it is essential to ensure that the benefits from regulation outweigh consequential costs."[2]

The takeover threshold and Treasury arguments in support of the MBR

2.2 Corporate control regulation is contained in Chapter 6 of the Corporations Law, which regulates the procedures for takeover bids, the conduct of bidders and targets, and more recently the process for resolving takeover disputes. Section 606 of the Law prohibits the acquisition of shares beyond a holding of 20 per cent of the total voting shares in a company, subject to a number of exceptions. The principal exception is the acquisition of shares made under a takeover offer which complies with a takeover scheme ('Part A' bid) or takeover announcement ('Part C' bid). As a result, corporate control is acquired after a takeover offer is made. The prohibition has the effect of making unlawful any attempt to acquire control prior to the making of a takeover offer.

2.3 The Treasury paper set out the proposal for the adoption of the MBR. It noted that an auction facilitates price competition in the market for corporate control but imposes transactional costs and adds significantly to the costs of a bid and takeover premium. "An auction potentially leads to an increased takeover premium," the paper added, thereby discouraging "prospective bidders of other targets who will expect higher bid prices." Efficiency problems can also result from defensive tactics by target directors who may encourage an auction or bidding war in order to frustrate the bid. Defensive behaviour in the face of a pending takeover "can be considered to be a market inefficiency through the inefficient use of corporate resources and may deprive target shareholders of a takeover premium if the bid is frustrated."[3]

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1 See *Corporate Law Economic Reform Program Strategy Document*, March 1997.

2 Corporate Law Economic Reform Program: Proposals for Reform: Paper No.4: *Takeovers*, The Treasury, 1997, p 7.

3 Corporate Law Economic Reform Program: Proposals for Reform: Paper No.4: *Takeovers*, The Treasury, 1997, p 22.

2.4 The Treasury paper advanced four arguments in support of the MBR, as practised in jurisdictions such as the UK. According to the paper, the introduction of the MBR would lead to increased certainty as to the outcome of a bid, lower bid costs, smooth the bid process and discourage rival bidders from 'free-riding' on the initial bidder's efforts.[4] Although the MBR would preclude rival bids and the opportunity for auctions, it would not decrease price competitiveness in the market for corporate control because it was "in the interests of the seller to get the best price possible for the control parcel."[5] In practice, it was likely that a controlling interest would attract bids from more than one prospective bidder and that these would include a premium for control, which under the new rule would be offered to all other shareholders.

2.5 The paper also set out the conditions that would apply to the MBR. The conditions would need to take account of the fact that control would already have passed at the time of the pre-bid acquisition. The implication of the change in control is that shareholders in the target company should be given the opportunity to exit the company completely and on the same terms as the control transaction. This would require the bidder to make an unconditional bid for all shares of the target company immediately following the control transaction. It would also require the bidder to offer the same bid price to all shareholders. The paper noted that the risk of allowing conditional mandatory bids is that, if the conditions are not met, the bidder would have acquired control but minority target shareholders would have lost the opportunity to exit the company.

Basic premise questioned by ASIC

2.6 In its submission to the PJSC, the Australian Securities and Investments Commision (ASIC) responded to the Treasury proposal. ASIC questioned the value of the MBR as a mechanism for the efficient allocation of resources. The submission stated that "if takeovers are to serve as a tool for the efficient allocation of resources then it would seem best that any bidder should be prepared to test the relative efficiency of its proposed allocation of the target's resources against the allocations proposed by any rival bidders."[6] ASIC also argued that an auction best promotes the economic benefits that are meant to flow from a takeover. Further, ASIC analysed the arguments advanced in favour of the MBR and concluded that they were neither germane nor compelling.

2.7 ASIC questioned the argument that prospective bidders are discouraged by the current prohibition in the Law and are reluctant to make bids because of the risk of being involved in a bidding war or being an unsuccessful bidder. ASIC suggested that the evidence adduced to support this proposition was largely anecdotal; in fact it appeared that bidders and foreign bidders in particular are active in the takeovers market. The ASIC submission advised that:

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4 The arguments used in favour of the MBR are referred to in the literature. See, for example, Easterbrook F H and Fischel D R, "The Proper Role of a Target's Management in Responding to a Takeover Offer", *Harvard Law Review*, Vol 94, 1981, pp 1161-1177.

5 Corporate Law Economic Reform Program: Proposals for Reform: Paper No.4: *Takeovers*, The Treasury, 1997, p 22.

6 Australian Securities and Investments Commission, Submission 3, p 3.

> In particular, it should not be assumed that there is any necessary nexus between the current level of takeover activity in Australia and the absence of a mandatory bid. It is asserted that certain bidders, particularly foreign bidders, are reticent about making bids where they cannot have some previous assurance of success. That assertion may not sit well with: (a) the significant numbers of unsuccessful bids which are made; and (b) the prominent involvement of foreign bidders in the Australian takeovers market. (Footnote: Data available to ASIC suggests that almost half of all takeover offers for Australian targets are made by foreign bidders or subsidiaries of foreign bidders.)[7]

ASIC analysis of the MBR - mooted advantages overstated by Treasury

2.8 ASIC submitted that, apart from attracting more bids because prospective bidders will have a greater degree of certainty, the other three advantages which the Treasury paper suggested would flow from the MBR are a consequence of the absence of rival bidders offering higher prices once control has passed to the new controller.[8] To the extent that the MBR will lower bid costs, as suggested by the Treasury paper, it will do so by allowing the prospective bidder to pay less than a market price because, if there is no auction for control, rival bidders will not incur such costs. ASIC also commented that a smoother bid process is the result of a friendly bid and the MBR will “often just be another way for bidders and targets to organise a friendly bid.” It was no advantage therefore to advise, as the Treasury paper did, that the MBR will deter defensive tactics employed to frustrate a takeover bid when those tactics will not be used in any event. The Treasury paper also suggested that the MBR is advantageous because it will discourage subsequent bidders from ‘free-riding’ on the efforts of the initial bidder. However, ASIC advised that before committing resources to a large scale acquisition, a well-advised rival bidder will undertake its own research and due diligence. The competitive advantages of ‘free-riding’ were not as great as suggested in the Treasury paper as “all bidders will incur their own search costs and if an auction occurs each bidder (including the initial bidder) will take advantage of information disclosed by its rivals.”[9]

Lower bid prices

2.9 Another doubt raised by ASIC concerned the assumption that the MBR would lead to higher bid prices as a result of the increased price competition in the market. The Treasury paper advised that in practice a significant parcel of shares in a company would attract bids from more than one buyer, which would include a premium for control. However, ASIC contended that if more bids are made for the controlling interest, “it should also mean that average bid prices will be lower.”[10]

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7 Australian Securities and Investments Commission, Submission 3, p 4.

8 Australian Securities and Investments Commission, Submission 3, pp 5-7.

9 Australian Securities and Investments Commission, Submission 3, p 7.

10 Australian Securities and Investments Commission, Submission 3, p 3.

Comparison with the UK City Code

2.10 The Introduction to the *City Code* states that the Code operates principally to ensure fair and equal treatment of all shareholders and that it is not concerned with the merits or commercial advantages or disadvantages of a particular takeover. Rather, the Code represents the collective opinion of professionals in the field on what are good business practices and how equality of treatment for all shareholders is achieved.[11] In expressing support for the MBR, submissions referred to the mandatory bid provisions that have operated in the UK since 1968. Although the MBR is a small percentage of overall takeover bids (between 5 and 15 per cent), the certainty of outcome associated with the mandatory bid will encourage bidders to "bargain up the price to gain a premium, thereby heightening price tension in the market."[12]

An unconditional bid

2.11 There are several important differences between the UK model and the MBR as proposed in the Bill. First, under the *City Code*, a mandatory bid is triggered if a bidder acquires 30 per cent or more of the voting rights of a company. The bid is, however, subject to a minimum acceptance condition (50 per cent of the share capital). Mr Lee described the essential elements of the MBR:

> **Mr Lee**—A mandatory bid should have no conditions attached to it except that it must be conditional on the bidder achieving acceptances to take him to over 50 per cent. Until the offer document is posted, we place certain restrictions on the exercise of control by the offerer. He cannot appoint anybody to the board nor can he exercise the votes attaching to the shares that he has bought. If a party holds between 30 per cent and 50 per cent, any shares that that party buys will automatically trigger a mandatory bid. Once a party holds over 50 per cent, there is no restriction on any further purchasing. [13]

2.12 Mr Peter Lee also advised that the 30 per cent figure is a control threshold reflecting effective control of a UK company:

> **Mr Lee**—I think, philosophically, as I said earlier, the key thing is control as opposed to influence. I think we felt that 30 per cent, in a general sense, is where you are likely to get control of a UK company. The acid test, I suppose, is whether somebody with less than 30 per cent is likely to be able to push through a resolution to change the whole boardroom and get themselves and their colleagues onto the board. Anecdotally, I suppose there have been one or two attempts over the years by people with less than 30 per cent to do

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11 *City Code* Introduction, 1 The Code, A1.

12 Securities Institute of Australia, Submission 6, p 2.

13 Mr Peter Lee, Committee Hansard, 15 March 2000, CS 2.

> that and they have tended not to achieve it. So I think it is control that we are focusing on and that is why I think 30 per cent is about right in the UK.[14]

2.13 As proposed in the Bill, the threshold required to trigger the mandatory bid is 20 per cent. In the Australian context, the statutory threshold is "a number that is of significant influence and pressure but is not control."[15] The 30 per cent control threshold implies that a bidder who acquires an interest of at least 30 to 50 per cent must extend its offer to all shareholders at the same price at which it acquired control. Submissions therefore expressed doubt that the amount received by a majority shareholder for its interest would be a control premium since effective control had not passed to the bidder. In the UK, as Mr Lee advised, there is no evidence to suggest that the price at which the controlling shareholder sells its shares is done at other than a full price:

> **Mr Lee**—From our experience—and that is all it can be—over the last 30 years and more there really does not seem to be any evidence that the best price is not achieved by the people selling the controlling block. There has never been any sort of muttering or comment that I am aware of to that effect. So I think the lack of a public auction does not actually militate against the ordinary shareholder. I think the best price is obtained by the system that we have at the moment. I think very often it is arguable that perhaps the buyer of that block is prepared to pay a very, very full price to get control of the company.[16]

Consideration to be offered

2.14 The second difference relates to the bid itself. As proposed in the CLERP Bill, the bid must include a cash offer, which is at least equivalent to the highest price paid by the bidder in the previous four months. This gives target shareholders the option of exiting the company should they wish. Alternatively, the bidder may offer scrip-for-scrip, or a combination of cash and scrip. In evidence to the PJSC, Mr Ted Rofe, Chairman of the Australian Shareholders' Association Ltd, emphasised the significance of a scrip-for-scrip offer in making the bid more attractive for target shareholders:

> **Mr Rofe**—I noted that under the UK rule the bid can only be a cash bid. Mr Lee outlined the two main reasons for that. I do not think it is necessary provided that there is a cash alternative. Of course, from a shareholder's point of view, particularly with the presence of capital gains tax rollover relief, in many cases a scrip bid will be more attractive than a cash bid, so it may be in the interests of both

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14 Mr Peter Lee, Committee Hansard, 15 March 2000, CS 5.

15 Mr John Green, Committee Hansard, 15 March 2000, CS 15.

16 Mr Peter Lee, Committee Hansard, 15 March 2000, CS 3.

> the bidder and the target company shareholders to have a scrip alternative available.[17]

2.15 A substantially different philosophy underpins the bid provisions which operate in the UK. There the bidder must in effect offer cash.[18] According to Farrar's Company Law, the right of withdrawal is a fundamental element of the rule since "shareholders who are already minority shareholders under one controlling shareholder should not be compelled to continue under a different controlling shareholder."[19]

> **Mr Lee**—I suppose the philosophy in the UK is that if somebody gets control of your company then you should be given the chance to get out of the total group—that is, get cash as opposed to being offered shares in the bidding company, which means that you are going to remain a shareholder of that enlarged group. The philosophy that underlies it is that shareholders should be able to get out, completely, for cash. In the UK, we also have capital gains tax rollover provisions which only apply in the case of a scrip offer. But, certainly, there has never been any sort of wish that the mandatory bid should be other than cash. That has been the position for many, many years.[20]

EC Commission Directive on takeovers and position in France and Germany

2.16 As part of its attempt to create a 'level playing field' for takeovers, the European Community (EC) Commission has proposed a Directive on takeover bids which lays down certain basic principles and minimum requirements for the conduct of takeovers, particularly as regards the transparency of the takeover process.[21] The rationale for the harmonisation of takeover regulation, as stated by the Commission, is the removal of takeover barriers between member states which may act to hinder corporate restructuring:

> Opportunities for acquiring companies in different Member States are still uneven. Takeover barriers are mainly due to either the different level of capitalisation of national markets, or to company

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17 Mr Ted Rofe, Committee Hansard, 30 March 2000, CS 54.

18 The bid is conditional only upon the bidder receiving 50 per cent acceptance (this condition is required to be included in the mandatory bid): *City Code*, Rule 9.3. See also Mr Peter Lee, Committee Hansard, 15 March 200, CS2.

19 Farrar J H, Furey N E and Hannigan B M, *Farrar's Company Law*, London, 1991.

20 Mr Peter Lee, Committee Hansard, 15 March 2000, CS10.

21 See *The Amended Proposal for a Thirteenth Council Directive on Company Law, Concerning Takeover and Other General Bids* (1997). The first proposal for the takeovers directive was presented in 1989 and amended in 1990. A streamlined framework directive was presented in 1996 and amended in 1997. A reservation by Spain concerning Gibraltar prevented adoption of a political agreement, at the June 21 1999 Internal Market Council, on a common position in respect of the Commission's proposal.

> law provisions which may ensure that the control of a company remains in the hands of 'friendly' shareholders even beyond the context of a takeover bid (if, for example, certain categories of shares enjoy disproportionate voting rights). There is thus no 'level playing field' for takeovers throughout the Union which means that in practice takeover activity is concentrated in a few Member States. The Commission is aware that these obstacles may hamper the restructuring of Community companies.[22]

2.17 The proposed framework Directive includes the enactment of the MBR by member states. Article 4 of the Directive would require any person acquiring control to make a full takeover bid for all remaining shares. Thereby all shareholders, not merely the controlling shareholder, would have the opportunity to exit the company. The Directive also requires member states to enact more detailed rules in accordance with their own regulatory structures and practices. The objective of the Takeovers Directive is to provide an equivalent protection throughout the Union for minority shareholders when control has passed:

> In the case of the acquisition or change of control of a listed company, the proposed Directive would require Member States to adopt specific national rules to guarantee that minority shareholders were protected. The full mandatory bid method (the UK method) is seen as the only means of protecting the minority shareholders of a listed company.[23]

2.18 However, a threshold acquisition is not specified in the Directive nor is 'control' defined.[24] While the EU Internal Market Council has yet to ratify the directive, the MBR has been adopted by France and Germany.

2.19 The objective of French regulation, of which the MBR is the cornerstone, is the protection of minority shareholders and the maintenance of the equal treatment for all shareholders.[25] The substance is to require a bidder that exceeds a threshold of 33 per cent of voting shares to make a full bid for the remaining shares, except in the case of block acquisitions where the threshold is 50 per cent. Until 1998, the mandatory bid threshold was 50 per cent of voting shares and the bidder was exempt from this rule if it could demonstrate effective control of the target over several years prior to the request for exemption.[26]

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22 Hutson E, *An International Comparison of Takeover Regimes,* February 2000, p 14 quoting from EC Company Law.

23 EC, Internal Market, Company Law, Accounting and Auditing: *Proposed Takeovers Directive – Questions and Answers*, p 7.

24 The earlier 1990 amended proposal contained a mandatory bid threshold. This was set at 33 per cent of the voting rights, although member states were allowed to fix a lower threshold.

25 Begg P F C, *Corporate Acquisitions and Mergers: A Practical Guide to the Legal, Financial and Administrative Implications*, Vol 2, Kluwer Law International, London, 1996, 7.58.

26 See Hutson E, *An International Comparison of Takeover Regimes*, February 2000, pp 20-22.

2.20 Similarly, the German Takeover Code is directed towards the protection of target shareholders.[27] A full bid for all remaining shares must be made immediately the bidder acquires control. As in the French regulations, the Code precludes partial bids for control under the MBR. The Code also specifies certain minimum price requirements. The mandatory bid threshold is not defined in percentage of voting share terms, although until 1997 the threshold was 50 per cent. A bidder has gained control when any of the following four triggering events occurs:

- a shareholder holds a majority of the voting rights;
- a shareholder holds majority voting rights based on an agreement with the other shareholders;
- a shareholder has the right to appoint or remove the majority of the members of the administrative, managing or supervisory board of the target company; or
- a shareholder obtains a percentage of voting rights, which, for the first resolution passed at each of the three preceding shareholders meetings of the target company, would have constituted a percentage of voting rights equal to at least three quarters of the share capital present and entitled to vote.[28]

Transparency of control transaction

2.21 Some submissions expressed doubts about the level of disclosure of the control transaction triggering the mandatory bid and the equal treatment of shareholders, because the parties may have agreed on side payments not disclosed to shareholders. ASIC indicated its concern that the MBR may create "more opportunity for the acquirer and the vendor to enter into undisclosed 'side deals' of a kind that violate the equal opportunity principle."[29] ASIC advised that, if the bidder and vendor have entered into an undisclosed side deal, not all shareholders would receive the same benefit, although the amount received by all shareholders under the offer would be the same. From a regulatory point of view, the burden of investigation and proof in seeking to uphold the equal opportunity principle would be increased:

> **Mr Cameron**—If the commission had grounds for concern that there was some side deal that was an unlawful deal, the benefits of which were not going to be shared with all other shareholders, then the commission could commence an investigation. But it would have to be satisfied that there were grounds to suspect a breach of the law before its formal powers of compelling people to answer questions and produce documents and so on would be triggered. So, in a sense, it is the risk or the possibility of a completely unknown side deal, or a side deal that is more along the lines of, 'Well, we will remember

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27 See Hommel U, "Regulating the Market for Corporate Control: Lessons from Germany", *International Journal of Business*, 3(1), 1998, p 101.

28 Hutson E, *An International Comparison of Takeover Regimes,* February 2000, p 19.

29 Australian Securities and Investments Commission, Submission 3, p 3.

> that you did this for us in the future.' It is that sort of nod and a wink type arrangement that it is not possible to legislate against.[30]

2.22 Similarly, Mr Rodd Levy, a Partner at Freehill Hollingdale and Page, cautioned that "The possibility of private auctions and secret deals under the guise of the mandatory bid rule flies in the face of this objective."[31] In addition, the lack of market transparency could lead to a loss of investor confidence. The submission from the International Banks and Securities Association of Australia noted that:

> …the rule could prevent shareholders of a target company from having access to important advice from the company's directors before control has passed to the bidder. Small shareholders could be particularly disadvantaged, as they are more likely to be presented with a *fait accompli* under the rule.[32]

2.23 Another concern raised by ASIC was the likely adverse effect of the MBR on foreign participation in Australia's equity market. Rather than encouraging foreign participation, the MBR would make Australia capital market less attractive. If control passes in circumstances where the market is not informed and is not confident about the equal treatment for all shareholders, that may have "adverse implications for the attractiveness and liquidity of the Australian equity market."[33]

Distressed vendor situation

2.24 Macquarie Bank Ltd and others submitted that the certainty which the MBR provides to a prospective purchaser would increase the number of bids for control, with the result that the controlling shareholder would seek to maximise the bid price. However, several submissions advised that vendors of control parcels may have particular reasons to sell their shares at a less than fair price and may accept a bid price which is below market value.[34] For example, Mr Levy raised the 'distressed seller' problem where a vendor is anxious to sell its shares rather than to negotiate the best possible price. Mr Levy stated that:

> I have been involved in transactions where the majority shareholder was prepared to sell at a price which was less than that achievable if an auction developed. This is particularly the case where the seller is in financial distress or is controlled by a liquidator, receiver or administrator.[35]

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30 Mr Alan Cameron, Committee Hansard, 30 March 2000, CS 63.

31 Mr R Levy, Submission 4, p 1.

32 International Banks and Securities Association of Australia, Submission 9, p 2. See also Mr Ted Rofe, Committee Hansard, 30 March 2000, CS 56-7.

33 Australian Securities and Investments Commission, Submission 3, p 3.

34 See Australian Securities and Investments Commission, Submission 3, p 5.

35 Mr R Levy, Submission 4, p 1.

2.25 On the other hand, Mr Alistair Lucas, Executive Director of Macquarie Bank Ltd, disputed the inability of the vendor to negotiate a fair price:

> **Mr Lucas**—In a distress situation, there are creditors involved, almost by definition. Those creditors are looking to have their debts associated to the maximum possible extent. It would seem to be a significantly value destroying move, were those creditors to say to the distressed sellers, 'Look, we do not care what price you get. You have got to sell it within two days.' It is much more likely that creditors in those situations would say, 'You have got to sell that asset to pay the debts. You are distressed, the debts have got to be paid. We want to see a process by which we get the maximum possible price.' Of course, a corporate auction can be run quickly in terms of the time it takes for distressed assets to be worked out.
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> In the case of a liquidator, my experience is that liquidators are very, very assiduous in seeking out the highest possible price, and of course they have a statutory obligation so to do. My experience has been that it does not really matter whether a vendor is financially sound or distressed; it is a pretty general rule that vendors want the highest price and seek to get such.[36]

Alternative proposals

Irrevocable undertakings

2.26 To solve the problems posed by takeovers, a number of submissions suggested an alternative change of control process. The alternative proposals would achieve the same objectives of the MBR and leave open the possibility of price competition. The proposals were supported by ASIC and Mr Rodd Levy, who referred to the practice in the UK of accepting irrevocable undertakings. Under the *City Code*, a bidder can accept "irrevocable commitments" (as they are called) from shareholders that, in the absence of a higher bid emerging, they would accept the bidder's takeover offer. This alternative would allow prospective bidders to obtain a commitment from the vendor of the control parcel, while at the same time allowing for the possibility of an auction before control had passed. The alternative would also leave a role for directors of the target company to participate in the takeover process and "give some prospects for the minority shareholders of eventually a higher price emerging."[37] Mr Levy stated that:

> Irrevocable undertakings have long been a feature of the UK takeovers practice, and it is my understanding, that they have worked well to ensure a smooth takeover process and benefits for all shareholders. Similar arrangements have also been a feature of Australian takeovers practice in the last few years (though only in

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36 Mr Alistair Lucas, Committee Hansard, 30 March 2000, CS 30.

37 Mr R Levy, Submission 4, p 2.

> respect of shares up to 20% of the target company). This practice has emerged to overcome the strictness of the rule in section 698 (as evidenced in the *Aberfoyle Ltd v Western Metals Ltd* decision). These arrangements have taken the form of conditional sales or options which have been conditional on no higher bid emerging. Examples are found in *Savage Ltd v Pasminco Investments Pty Ltd* and in *Cultus v OMV*.[38]

2.27 However, Mr Bruce Dyer, a Partner at Blake Dawson Waldron, submitted that irrevocable commitments permitted under the *City Code* are not required to be conditional in the manner described and only indicate in what circumstances the commitment will cease to be binding:

> That is apparent from Note 3 to Rule 2.5 of the City Code which indicates that, when an announcement gives details of such irrevocable commitments (as required by Rule 2.5) it "must specify in what circumstances, **if any**, they will cease to be binding, for example, if a higher bid is made" (emphasis added). It is our understanding that bidders in the UK commonly obtain irrevocable undertakings from target shareholders which do not permit the shareholder to accept a competing bid (although the shareholder would be entitled to receive any increased consideration offered by the bidder holding the undertaking).[39]

2.28 Mr Dyer also noted that the possibility of obtaining irrevocable commitments from target shareholders to accept an offer is available in voluntary bids as well. The *City Code* permits a bidder to seek assurance as to the success of the bid before it is made:

> The possibility of obtaining of "irrevocable commitments" from target shareholders to accept an offer makes that assurance available in "voluntary bids" as well. As we understand the requirements of the City Code, a bidder can obtain irrevocable commitments which will assure success of the bid without needing to make a mandatory bid (which would be subject to greater constraints than a voluntary bid) regardless of the percentage of shares to which the undertakings relate. Indeed, the availability of such irrevocable commitments may well determine whether a voluntary bid proceeds.[40]

Share tender system

2.29 In evidence to the PJSC, Mr Alan Cameron AM, Chairman of ASIC, advised that to some extent a rule equivalent to the MBR already exists in the form of ASIC

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38 Mr R Levy, Submission 4, p 2.

39 Mr B Dyer and Mr G Hone, Submission 11, p 2.

40 Mr B Dyer and Mr G Hone, Submission 11, p 2.

Policy Statement 102, *Tender Offers by Vendor Shareholders*.[41] Under that policy a bidder can acquire major parcels of shares prior to a public announcement and takeover offer. Although ASIC had received few requests to do so, Mr Cameron indicated that ASIC would be prepared to adapt the policy provided minority shareholders were not compromised. However, according to Deutsche Bank, the reasons for this were due to the unwillingness of potential vendors to offer publicly their holdings for tender:

> The ASC tender system is a lengthy process, and assumes a shareholder is willing to hold out to the world that it is a definite seller, even before a minimum price is set. This is a position that few asset owners ever wish to adopt: the limited number of share tenders ever undertaken bears this out. The existence of ASC PS 102 does not remove the need for a mandatory bid rule.[42]

Postponement of the introduction of the MBR

2.30 The CLERP Act substantially reformed the takeover provisions in Chapter 6 of the Law. The procedures for bidders and targets were simplified and streamlined. In addition, the role of the Corporations and Securities Panel (the Panel) in resolving takeover disputes was considerably strengthened and enhanced. According to ASIC, "The new Panel provisions have the capacity to cause a major shift in the whole climate in which mergers and acquisitions are conducted. When changes in capital gains tax rollover relief are also taken into account, it will be seen that the whole scheme of regulation applying to takeovers is about to be substantially transformed."[43] In light of these reforms ASIC suggested that it would be useful to observe the new takeover regime in operation for a period of 12 months, before any decision was made regarding the introduction of the MBR. ASIC added that if the reforms have their intended affect "it may be found that that a mandatory bid rule is unnecessary."[44]

Potential harm to bidders in the absence of the MBR

2.31 Mr John Green, NSW President and National Councillor of the Securities Institute of Australia, advised that every auction for control involves the risk of a bidding war between rival bidders, with consequent harm to a bidder's reputation and its assets if it is unsuccessful. Such harm may result from an unsuccessful bid, litigation, market revaluation of the bidder's asset quality, or the defensive tactics by the target in a hostile takeover. This risk is borne by all bidders in an auction. Mr Green described the nature of the harm:

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41 See Mr Alan Cameron, Committee Hansard, 30 March 2000, CS 62 and Australian Securities and Investments Commission, Submission 3, p 5.

42 Deutsche Morgan Grenfell, Submission 12, p 3.

43 Australian Securities and Investments Commission, Submission 3, p 2.

44 Australian Securities and Investments Commission, Submission 3, p 2. See also Mr Alan Cameron, Committee Hansard, 30 March 2000, CS 61.

> **Mr Green**—There have been a number of transactions in which I have been involved where parties have expressed significant interest in acquiring companies where there might even be a bid in place, a hostile bid. Those parties have said, 'We don't want to play in that game but, if you're able to deflect that bid, come and talk to us later. We won't do that. We don't make hostile takeover bids. We won't play in that arena. Even if we get a board recommendation, we don't want to play because the other party may challenge us, may litigate us, may do all sorts of things to damage us, and our reputation is worth more to us than this particular transaction.'[45]

2.32 Macquarie Bank Ltd advised that potential bidders who undertake a risk/reward assessment therefore may chose not to make a public takeover bid and face the risks involved:

> If the only way that a corporation can participate in an auction for corporate control is to make a public takeover offer (with the requisite cost that this involves – organisation of funding, time to manage a public process, flagging public strategy), it usually will not wish to join such a public process.[46]

Improved corporate performance and price maximisation

Corporate performance

2.33 Macquarie Bank Ltd submitted that, as well as encouraging increased takeover activity, the MBR will improve corporate management. The greater threat of takeover arising from the MBR should deliver worthwhile benefits to shareholders in higher management performance and increased price tension in the market for corporate control.[47] The Australian Shareholders' Association Ltd (ASA) supported the introduction of the MBR as proposed in the Bill because it would lead to improved corporate performance and better communication with shareholders:

> **Mr Rofe**—One argument that has come up in some of these submissions is that a more competitive takeover environment might encourage companies to take the defensive action before the bid rather than after; that it is not really in shareholders' or anyone's interest for directors to wait until they receive a bid or suspect that they are about to receive a bid, to say 'Look, we've got great plans; we're going to be profitable next year; we've got all these strategies in place,' which, at that stage, often sounds a bit unconvincing. Rather, if there were this environment of increased takeover activity, those boards of directors would be saying to themselves all the time,

45 Mr John Green, Committee Hansard, 15 March 2000, CS 19.

46 Mr A Lucas, Submission 5, p 4.

47 See for example, Mr A Lucas, Submission 4, p 3.

> ‘We want to develop the right strategies; we want to let our shareholders know that we are developing the right strategies.’ I would suggest that, if that is the case, if they can convince shareholders and the market that they are doing the right thing, the share price will reflect the potential and they will be less susceptible to takeover activities.[48]

Price maximisation

2.34 Several submissions argued that target shareholders would be disadvantaged because the use of the MBR to acquire a controlling interest would defeat an auction for control. These submissions advised that the MBR would result in less price tension. The lack of price tension meant that the controlling shareholder would not get the best possible price for its control parcel. However, Mr David Quigg, a Partner at Kensington Swan, advised that minority shareholders may prefer a negotiated sale rather than the uncertainty of a public auction:

> The controlling shareholder has a choice. It is not required to accept any offer from the prospective purchaser. Presumably it will only accept the offer if it believes that it is unlikely an auction would achieve a greater price. It is therefore the controlling shareholder’s choice to go auction. I believe that the controlling shareholder would prefer to have its flexibility enhanced by the Mandatory Bid Rule (either commit or go to auction). I believe on balance that the Mandatory Bid Rule would also be favoured by the minority shareholders. Allowing the simple mandatory auction regime to proceed anticipates that the principles of the auction theory always apply in practice. That is, that there are competing offerors and due to their competing offers the maximum price is achieved. Often in fact there is a lack of multiple purchasers even in the best run tender or auction situation. Resort is made to “phantom” purchasers. Such arrangements cannot be used in the present compulsory auction regime applicable in either New Zealand or Australia. One clearly knows from market information whether or not there are any competing offers. Taking this into account, there may well be a better result for the minority shareholders in a negotiated sale rather than a public auction. The flexibility given by the Mandatory Bid Rule gives the possibility for a private treaty sale to be negotiated with the controlling interest. The subsequent mandatory bid

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48 Mr Ted Rofe, Committee Hansard, 30 March 2000, CS 60. The evidence on takeovers supports the view that underperforming companies are more likely to be the target of a takeover than successful ones. Brown and da Silva report that “the sharemarket evidence unequivocally supports the hypothesis that firms that make takeover bids are, in general, firms that have done well and look to the takeover market as a means of building on their performance. Target firms, on the other hand, typically display sharemarket returns that rank them firmly in the bottom half of corporate achievers.” See Bishop S P and da Silva R, “Takeovers: Who Win?”, *JASSA: The Journal of the Securities Institute of Australia*, Issue 4 (Summer), 1997, p 4.

> requirement means that minority shareholders share in the same premium achieved by the controlling shareholder.[49]

2.35 Similarly, Mr Alistair Lucas, Executive Director of Macquarie Bank, advised that the MBR would not lead to reduced price tension for corporate control and a less effective takeover process:

> **Mr Lucas**—In my experience, getting an auction going—there have been a number of public auctions—in a public company situation is very difficult. Quite often when a takeover is being made, the offeror companies are making very major corporate change decisions. They are increasing their size, maybe 20 or 50 per cent, or even doubling their size by making a takeover offer. When a corporation makes a takeover offer it wants to be certain that success will occur, otherwise it has flagged to the whole market a major change in strategy and has then failed if it does not succeed. That can be a significant issue in relation to the confidence that investors have in that company. That company, by indicating that it wishes to make a takeover, may have made it clear that it is weak in a particular market. It may have made it clear that it believes its current level of operations is not sufficiently diversified. A whole range of strategic issues can be and are pretty clearly read by analysts into corporations by the process of making takeover offers. Companies do not make takeover offers lightly. It is much harder in my experience for a corporation to make a decision to make a takeover offer in a situation where they know someone has already made an offer and so it is already contested. I have heard countless times, 'We are not interested in bidding in a contested situation.' That is a common statement made by boards. It is an unattractive situation to be in a public auction process. The process that the mandatory bid rule would allow is a private auction. A private auction is a much more acceptable way for corporations to conduct an auction because they do not have to make their position public. They do not have to make their pricing public. They do not have to line up the finance in advance. It is a much easier process for the corporations to deal with.[50]

Theoretical analysis of the MBR

2.36 The Centre for Corporate Law and Securities Regulation, University of Melbourne, submitted a 1997 paper which examines the MBR from an economic perspective.[51] The paper analyses the effect of the MBR on the outcome of a control

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49 Mr D Quigg, Submission 1, pp 1-2.

50 Mr Alistair Lucas, Committee Hansard, 30 March 2000, CS 29.

51 See Centre for Corporate Law and Securities Regulation, University of Melbourne, Submission 2, which attached an article by Bergstrom C, Hogfeldt P and Molin J, "The Optimality of the Mandatory Bid Rule", *Journal of Law, Economics and Organisation*, Vol 13, 1997, pp 433-451.

contest between two rival management teams in a firm where no controlling position exists. The theoretical model used is that of a firm which is privately owned by a founder/entrepreneur. The paper also adapts the Grossman and Hart framework of security and private benefits that accrue to the two rival teams. The security benefits are the net present value of the firm's projects that accrues to all shareholders of the firm. Private benefits are defined as net of any costs making a bid and may measure the attendant psychic value generated by control over the firm.

2.37 The MBR requires that when control shifts all shareholders should have the opportunity to exit the company and the chance to sell their shares at the price of the control premium. Giving all shareholders such an option would seem fair and equitable. However, by changing the conditions of the control contest between the rival teams, the MBR triggers several counteracting effects on shareholder wealth. The different effects on shareholder wealth are brought about by the relative value of the security and private benefits to each management team. The model yields several general and specific outcomes which indicate when the MBR is in the interests of target shareholders:

> In the general case with two-sided private benefits, the MBR is aligned with the shareholder's interests only over a comparatively small set of values in the parameter space. Hence the implementation of the MBR does not generally benefit the target shareowners. Specifically, if the private benefits of the two contestants are about the equal size, its effect on the shareholder's wealth is uniformly nonpositive. In fact, unless the difference in private benefits is large, the target shareowners encounter a loss from the implementation of a MBR.[52]

2.38 On the other hand, these results contrast with that obtained when the private benefits are one-sided. If either the incumbent management or the rival team enjoy private benefits which are larger than its rival, then the adoption of the MBR is likely to increase shareholders' wealth:

> With one-sided private benefits, the difference in willingness to pay over private benefits between the two contestants is maximised. Consequently, since their willingness to pay is relatively more similar over security benefits, the target shareholders exploit this fact by allowing nonpartial bids.[53] Hence the special case with one-sided private benefits provides the strongest case for the MBR because it is perfectly aligned with the shareholders' interests.[54]

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52 Bergstrom C, Hogfeldt P and Molin J, "The Optimality of the Mandatory Bid Rule", *Journal of Law, Economics and Organisation*, Vol 13, 1997, p 435.

53 The *willingness to pay rule* refers to the situation when the relative proportion of either benefit is greatest thereby intensifying competition for control of the firm.

54 Bergstrom C, Hogfeldt P and Molin J, "The Optimality of the Mandatory Bid Rule", *Journal of Law, Economics and Organisation*, Vol 13, 1997, pp 441-2. See also Bergstrom C and Hogfeldt P, *An Analysis of the Mandatory Bid Rule*, Stockholm School of Economics Working Paper No 32, November 1994.