

CHAPTER 3

CONCLUSIONS AND RECOMMENDATION

Rationale for the final MBR proposals – the protection of minority shareholders

3.1 The questions before the PJSC during this inquiry were very similar to the questions that were faced by Treasury when it proposed the introduction of the MBR as part of its review of Chapter 6 of the Law. The CLERP paper addressed two basic issues: Is the MBR necessary to solve the efficiency problems involved in an auction for corporate control, and if so, are the conditions attached to the MBR sufficient? The difficulty with the CLERP proposal, however, was that it attached too much importance to achieving efficiency and transactional certainty in the takeover process. In identifying the efficiency problems involved in an auction, which could lead to higher bid costs and increased premiums, the paper presented the MBR as a costless option for acquiring and relinquishing corporate control. The removal of an auction could result in “smaller control premiums being paid in some instances”, but it was more likely that the initial bid would succeed. It could be expected therefore that more bids would be made as a result of the greater certainty of outcome, although the CLERP paper acknowledged there would be “some reduction of market transparency.”¹

3.2 Subsequently, a package of benefits or rights of minority shareholders was included in the provisions of the CLERP Bill consistent with the recommendations by ASIC to Treasury. A number of prescribed conditions would apply to the MBR. The bidder must disclose to the controlling interest that its agreement to sell will trigger the mandatory bid, and it must not exercise control of the target until the first offer under the bid is made. Several conditions that apply to takeover bids would also apply to a mandatory bid. Target shareholders would have the benefit of an independent assessment of the fairness and reasonableness of the bid and the bidder’s statement would contain information about the financing for the bid.² The policy underlying the modified MBR was stated in the Explanatory Memorandum to the Bill:

...all target shareholders will have the opportunity to sell their shares at a fair price and to benefit from the premium a bidder for control places on the securities...minority investors will be protected from being offered insufficient consideration for their holdings, since the procedure will encourage controlling and institutional investors to make an informed assessment about the appropriate premium for control, which will be required by the mandatory bid provisions of the law to be offered to small investors. Subject to the conditions applying to the mandatory bid procedure, the general procedure for

1 Corporate Law Economic Reform Program: Proposals for Reform: Paper No.4: *Takeovers*, The Treasury, 1997, p 23.

2 For a list of conditions contained in the Bill see the Introduction to this Report, paragraph 1.7.

undertaking a mandatory bid will be the same as for other takeover bids.³

3.3 The PJSC concludes that the final MBR proposals as contained in the CLERP Bill provide strong protection and safeguards for minority shareholders.

Comparisons with the UK and EC models

3.4 The MBR has long been a feature of the UK takeovers practice. As stated by Mr Lee the rule has worked well over the past 30 years and is a completely accepted feature of corporate and commercial life. Although the number of mandatory bids is relatively low, there is no evidence that the price at which the controlling shareholder sells its interest “is done at other than a very full price.” However, direct comparisons with the rule in the UK should not be taken too far. This is also the case for comparisons with the MBR in other EC countries which have adopted a more restrictive form of the MBR. The PJSC believes, however, that the MBR as proposed in the Bill, taken with the new compulsory acquisition powers and the recent changes to capital gains tax rollover relief, would operate in a significantly different, but no less beneficial, manner.

Distressed vendor situation

3.5 The PJSC found it difficult to assess the magnitude of the ‘distressed vendor’ problem and whether or not this would only occur in a minority of situations, or if at all. However, the PJSC noted that the concerns raised in submissions about a ‘fire sale’ situation where a distressed vendor is anxious to sell its control parcel and forego a higher offer are largely addressed by the conditions to which the mandatory bid is subject. In the PJSC’s view the package of rights or benefits attached to the use of the MBR acts to protect minority shareholders. In practice, it is likely that target shareholders who chose to sell will do so only after the board has advised them about the bid following the expert’s valuation. If a ‘fire sale’ has been agreed to, the bidder will face a high degree of risk as its bid may not be accepted by all shareholders. If shareholders deny approval of the bid, the bidder is kept from gaining 100 per cent control unless the bidder increases the offer price above the amount received by the distressed seller:

It should be recognised that if an anxious seller disposes of its shares at something less than the best possible price, other shareholders in the target company would not be compelled to dispose of their shares to the offeror if they felt that the price offered under the mandatory bid was inadequate. In those circumstances, in order to achieve the necessary threshold to be able to compulsorily acquire all the shares held by the minority shareholders, the offeror might be compelled to offer a higher price under the mandatory bid or to increase the price

3 Explanatory Memorandum, paragraphs 7.4, 7.5 and 7.7.

offered under the mandatory bid above the price that may have been paid to the anxious seller.⁴

Alternative proposals

3.6 The PJSC concluded that there is a fundamental problem with the proposal for irrevocable undertakings, in that the initial bidder has no certainty that its bid will succeed. It is also unclear how irrevocable undertakings would work in practice. The conditions attached to the undertakings would need to be restrictive so as to leave open the possibility of an auction and the prospect of higher bids emerging from the auction. By organising a friendly bid between the bidder and target company, such undertakings could be used as a defence against a potential takeover. They may serve therefore to check rather than stimulate competition. The proposal also assumes a lengthy takeover period if the conditions that apply to the initial bid are to apply to the higher bid and successive higher bids.

3.7 ASIC Policy Statement 102, *Tender Offers by Vendor Shareholders*, which permits sales by tender of control parcels, has the effect of requiring a mandatory bid and allowing control to pass prior to the bid. To date, however, there has been little use of that policy. The tender system assumes that a shareholder is “willing to hold out to the world that it is a definite seller, even before a minimum price is set”.⁵ While ASIC is prepared to adapt the policy so long as investors are not compromised, the policy is not a workable alternative to the MBR. The PJSC believes that the MBR is particularly significant because it will alter the risk/reward balance for potential bidders. A reform to takeovers as significant as the MBR requires a legislative basis rather than the modification of an ASIC policy.

Theoretical analysis of the MBR and its implications

3.8 The paper submitted by the Centre for Corporate Law and Securities Regulation analysed how the application of the MBR affects shareholder wealth in a takeover contest. The paper derived a general design principle that characterised when the MBR was in the interests of target shareholders and when it was not. It also evaluated the MBR as a policy instrument in the context of the EC Commission’s Directive on takeovers. The analysis expressed doubts about the value of the MBR within the EC on several grounds, including the rule’s prohibition on partial bids:

By demonstrating that it is only quite restrictive conditions that he target shareowners actually gain ex post from implementation of the rule, the analysis exposes the unclear and insufficient motivation behind the MBR. In particular, the right to sell feature is not a free option and needs serious motivation from regulators. The relative

4 Arnold Bloch Leibler, Submission 7, p 3. See also Mr Ted Rofe, Committee Hansard, 30 March 2000, CS 56-7.

5 Deutsche Morgan Grenfell, Submission 12, p 3.

similarity of willingness to pay rule provides the answer to when the enactment of the MBR is really in the interests of the shareholders.⁶

3.9 The MBR proposed by the CLERP Bill is not subject to the same restrictive rules which apply to the MBR under the EC Commission's Directive, just as the essential elements of the MBR are not similar to the principles underlying the UK *City Code*. The PJSC noted the diversity of rules and conditions applying to the MBR, although the basic principles that govern the protection of minority shareholders are common to all jurisdictions. The first is the equal opportunity principle and the second, that all shareholders have a right of withdrawal. The PJSC noted that the same principles underlie the package of benefits or rights of minority shareholders contained in the CLERP Bill. However, the theoretical analysis is a useful tool in understanding how shareholders' wealth is maximised in a takeover contest where there is no controlling position. In expressing doubts about the implementation of the MBR within the EC, the authors of the paper were advocating a less restrictive regime, which delivered a more efficient management and maximised shareholder wealth.

Mandatory bid threshold and control premium

3.10 A feature unique to the MBR as proposed in the Bill is the 20 per cent threshold, compared to the higher control thresholds in other countries (between 30 and 50 per cent). The reasons for the choice of the 20 per cent threshold were alluded to in evidence to the PJSC and they have to do with the environment of corporate takeovers in the 1960s. It was felt then that the figure should be below the threshold required for effective control but should reflect significant influence and pressure.⁷ Theoretically the premium for control offered by a bidder belongs to the shareholder which can deliver control to the bidder, be it at 30, 40 or 50 per cent. If control has not changed, it does not follow that the amount received is a control premium even though it may exceed the sharemarket price. The PJSC accepts that effective control can be demonstrated in some instances where the control parcel is below 20 per cent, because of the spread of shareholders in the particular company or the size of the company. However, in most cases effective control would not have changed with the agreement to sell. The MBR therefore is more liberal than other forms of the MBR because it allows a bidder to gain full control without first having acquired a controlling interest (between 30 and 40 per cent). The PJSC believes that, in practice, the rule will lead to an incremental offer or offers by the bidder to gain a minimum 90 per cent acceptance by target shareholders. At 90 per cent the bidder would be able to compulsorily acquire the remaining 10 per cent of shares. Therefore it is in the interests of the majority shareholder to seek offers from other potential bidders with an interest in acquiring its holding in order to maximise the price at which control eventually occurs. As Mr Alan Cameron noted, mandatory bids will carry the risk that the bidder will achieve only partial control and not 100 per cent ownership, unless it offers a full price or is prepared to raise the offer price:

6 Bergstrom C, Hogfeldt P and Molin J, "The Optimality of the Mandatory Bid Rule", *Journal of Law, Economics and Organisation*, Vol 13, 1997, p 446.

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

Mr Cameron—...one of the things that will tend to drive the price up in the first purchase will be the fact that the bidder will then be at risk of being stuck with that holding themselves because the bid must be fully unconditional. If that rule is preserved, if that condition is maintained as part of the parliament's approach, then it will be a very brave bidder who does not bid at reasonably full price or who is not prepared to raise the price, because they will not be sure of control in that situation...But you can read it either way. You can say either that it means there will be fewer bids, or that it means the bids will have to be at a price than the lack of an auction might have otherwise suggested...The other factor I would add in is the necessity to ensure that you get to control, because our experience in this country is that few bidders are really content with a situation where they will not get control.⁸

Corporate performance, price tension and better communication

3.11 The PJSC concluded that the primary argument against the MBR is that an auction for corporate control ensures that the maximum takeover premium over and above the sharemarket price is achieved. The relationship between price competition and the takeover premium was at the centre of this debate. However, the argument assumes that all bidders with an interest in acquiring control will participate in a public auction and that the risk/reward balance outweighs the potential harm to their asset quality if the bid is unsuccessful. It also assumes that greater value is created through an open auction for control. The PJSC, however, does not accept these propositions.

3.12 The PJSC concludes that the MBR will stimulate new competitive pressures in the takeovers market. The question of how these competitive pressures will be stimulated involves two dimensions: corporate efficiency and price tension in the market. The former concerns how the performance of incumbent management is affected by the increased threat of takeover and whether better communication with shareholders will result. The latter concerns the price tension which arises in the course of a private auction and, consequently, how large a premium the majority shareholder is able to negotiate for its interest. These pressures are factors that affect the pre-takeover value of the company rather than the price level at which the takeover occurs. The PJSC believes that a strong and active market for corporate control promotes higher corporate efficiency. All shareholders, regardless of whether they hold controlling interests or not, will benefit from improved performance by company management, better communication and increased price tension.

Recommendation

3.13 The PJSC recommends that the MBR as proposed in the CLERP Bill should be enacted.

⁸ Mr Alan Cameron, Committee Hansard, 30 March 2000, CS 66.

3.14 The PJSC also recommends a review of the operation of the MBR two years after its commencement, as foreshadowed by the Government at the time the CLERP Bill was introduced into Parliament.

Senator Grant Chapman

Chairman