Submission to the Corporations and Markets Advisory Committee in response to its Discussion Paper on Members' Schemes of Arrangement

Introduction

1. Allens Arthur Robinson is pleased to provide this submission to the Corporations and Markets Advisory Committee (***CAMAC***) in response to its Discussion Paper of June 2008 on Members' Schemes of Arrangement.

2. The key observation that underlies the majority of AAR's submission is that the scheme of arrangement procedure is generally working appropriately and effectively as a mechanism for the implementation of a control transaction. In our experience, there is a general acceptance within the business and legal communities that schemes are a legitimate alternative mechanism to Chapter 6 takeovers for this purpose. There are also strong economic policy reasons for maintaining the ability to undertake a control transaction by way of scheme, as schemes are of fundamental importance to maintaining an open and effective market for control of Australian listed entities. Accordingly, while AAR sees some scope for reform of the scheme provisions, we consider that those reforms should largely be 'tidy ups'. We see no reason for wholesale or 'revolutionary' reform.

3. Further, we do not see any need for schemes to try to replicate the features or principles of Chapter 6 (or vice versa, for that matter). A scheme is a fundamentally different process than a takeover bid under Chapter 6, and it is not appropriate to try to craft provisions designed for the takeover bid process onto that for a scheme. The scheme process already has built into it all of the protections for shareholders in Chapter 6, and more, through the Court's supervision of the scheme, including its involvement in approving the composition of classes voting on the scheme and its ultimate discretion whether or not to approve the scheme at the second Court hearing.

4. If there is one particular issue that does need to be addressed in the scheme provisions, it is section 411(17) of the Corporations Act. Schemes and takeovers should be seen as two different but alternative mechanisms for effecting a control transaction, and our law should not try to promote or prefer one at the expense of the other. The market is at this point now, and it is necessary to remove section 411(17) to reflect this.

Information to shareholders (CAMAC Paper, section 3)

Effective disclosure (CAMAC Paper, section 3.1)

Introduction of a 'clear, concise and effective' disclosure requirement

5. AAR supports the introduction of a 'clear, concise and effective' disclosure requirement. This would provide a statutory basis for reducing the incentive for scheme companies to

provide excess disclosure for the sole purpose of minimising liability (reforming the liability regime as discussed below will also assist in this regard). It would also achieve consistency in treatment with the regimes applying to other disclosure documents.

Incorporation by reference

6. AAR supports the introduction of a statutory mechanism for information to be incorporated into scheme disclosure materials by reference. We consider that this would be entirely consistent with, and would promote the objective of, clear, concise and (most importantly) effective disclosure.

7. We also consider that the effectiveness of disclosure for schemes would be enhanced if particularly detailed or complex information (such as detailed financial or technical information, summaries of transaction documents or material agreements and copies of independent expert's reports and related technical expert's reports) was to be made available separately as optional disclosure for those shareholders who wish to see it (for example, via the internet or ASIC).

Reform of disclosure requirements

8. AAR supports the reform of the prescriptive disclosure requirements for schemes so as to:

   (a) omit the requirements currently in Part 3 of Schedule 8 to disclose information which is arguably irrelevant or covered by general disclosure requirements (ie, all known information that is material to the decision by shareholders);and

   (b) specify precisely which Chapter 6D or Chapter 7 disclosure requirements (and related principles) should apply where the scheme consideration includes scrip (whether in the form of shares, other financial products or otherwise).

9. We recognise that some of the provisions of section 636 might need to be repeated in the scheme disclosure provisions, while recognising that not all of those provisions will be applicable to control schemes and that there will be many schemes that are not arranged to effect a control transaction.

Supplementary disclosure (CAMAC Paper, section 3.2)

10. We consider that there is no need to introduce a supplementary disclosure regime. The current process and legal requirements for providing supplementary information in schemes (ie, seeking Court approval and providing a period of notice which is reasonable in the circumstances) work appropriately and effectively.

11. It is not appropriate to try to craft a takeover bid supplementary disclosure regime onto a shareholder approval process where there is a body of law governing whether supplementary disclosure is necessary in order for the vote at the meeting to constitute an informed consent, and the fact that a scheme is a Court supervised process and the Court will have its own view as to what supplementary disclosure is required, and when. However, as there may be circumstances in which it will be appropriate for the Court to make orders in relation to whether supplementary disclosure is required and the manner in which that disclosure is to be made, we consider that an amendment to the legislation to provide that the Court may order that supplementary disclosure materials need not be despatched to members (but may be made available to members by other means, such as

through ASX announcements or through the scheme company's website, thus minimising costs for the parties and avoiding delays or timing issues associated with physical despatch) may be desirable. Such an amendment would provide the Court with a statutory basis for making such orders.

12. The current process and legal requirements relating to supplementary disclosure may mean that a scheme is arguably less flexible than a Chapter 6 takeover. In our view, this is no reason of itself to amend the scheme provisions – rather, this should be seen as a consequence of the different protections for shareholders that are afforded under a scheme as compared with a takeover bid (in particular, the fact that schemes are supervised by the Courts whereas takeovers are not). Proponents of control transactions can take this into account when selecting the mechanism by which they wish to proceed.

Liability and defences (CAMAC Paper, section 3.3)

13. AAR supports there being a specific liability regime for scheme disclosure similar to the regime for bids under section 631 (or, where relevant, the regime in Part 6D where scrip is offered to members of the scheme company under the scheme), and that this regime should operate to the exclusion of all other liability regimes (such as section 1041H of the Corporations Act, section 12DA of the ASIC Act and section 52 of the Trade Practices Act).

14. Further, AAR considers that the underlying objective in the legislation should be for there to be one overall liability regime that covers all disclosure documents and explanatory materials produced by companies – that is, not only bid and scheme documents but also explanatory materials provided to shareholders for transactions such as buy-backs, capital reductions, section 611 item 7 proposals and other proposals - and one regime of defences (including a general due diligence defence). This could be supplemented by certain specific liability provisions where appropriate (for example, the regime in section 729 that makes certain persons in addition to a company and its directors liable for prospectus disclosure).

15. AAR supports including in the legislation provision for both the purchaser and the scheme company to obtain the benefit of a due diligence defence in respect of the components of the explanatory statement for which they are each responsible. This would allow the parties to delineate responsibility in the explanatory statement between the purchaser and the scheme company. The legislation should explicitly provide that defences apply to both the purchaser and the scheme company in respect of the content for which each party is responsible.

Voting on schemes (CAMAC Paper, section 4)

Class voting (CAMAC Paper, section 4.1)

First hearing

16. AAR would not support an approach whereby a Court *must* make a binding determination on classes at the first Court hearing. Equally, if a Court considers it appropriate to do so in the circumstances of a particular scheme, there should be no prohibition to stop it from doing so.

Second hearing – curative power

17. AAR supports the proposal for the Court to be given an express 'curative power' at the second Court hearing to approve a scheme in circumstances where the classes may have been wrongly constituted. We see no disadvantages or risks with this proposal, and so any additional flexibility gained by this reform would be an enhancement to the current regime. It is obviously inefficient for a company to be required to start the process again when the proposed scheme has already been approved by a requisite majority of each of the appropriate classes.

Intending controller

18. We consider that there is no need for the legislation to provide that any votes cast in favour of the scheme by an intending controller or its 'associates' be disregarded. The class composition test currently applied by the Courts has the effect that an intending controller and its controlled entities would be prevented from voting on the scheme with other shareholders. Whether other associates of the intending controller should be precluded from voting should also be determined by reference to those tests. To simply apply the definition of 'associate' in sections 12(2)(b) and 12(2)(c) and the very broad definition of 'affairs' in section 53 to a voting exclusion requirement may result in persons who would not currently be regarded as a separate class, or otherwise subject to special treatment in the context of voting on the scheme, being disenfranchised.

Abolition of the headcount test (CAMAC Paper, section 4.2)

19. AAR supports the abolition of the headcount test with no new or modified test replacing it (ie, Option 4 in the CAMAC Paper). We share the views of the Law Council submission referred to in the CAMAC Paper that the headcount test is an anachronism. Our view on the other options listed in the CAMAC Paper are as follows:

    (a) Applications to the Court for dispensation of the headcount test involve unnecessary time, cost and uncertainty. Expanding this process to include more discretion (and therefore, uncertainty) would only exacerbate this. Accordingly, we submit that Option 2 in CAMAC's Paper (namely, expanding the judicial dispensing power) should not be adopted.

    (b) We consider that retaining a modified version of the headcount test as per Option 3 in the CAMAC Paper would add unnecessary complexity, in return for no material benefit.

    (c) We oppose the adoption of Option 5, as ambivalent or uninterested shareholders should not be able to defeat transactions.

20. However, we also note that no scheme has ever been voted down on the headcount test in Australia and, while we are aware of some transactions that have not been undertaken as schemes because of concerns around the headcount test, they are few in number. We would not wish the abolition of the headcount test to be seen as a reason for opening up any of the other approval thresholds for a scheme.

The voted shares test (CAMAC Paper, section 4.2, option 5)

21. The CAMAC Paper does not expressly request submissions on the voted shares test as an independent issue, though a modification of this test is flagged in Option 5 of section 4.2 as one possible replacement of the headcount test.

22. AAR is strongly of the view that the 75% of shares voted approval threshold for schemes should be retained in its present form and not supplemented in any way. Amongst other reasons, this is consistent with our overriding views that:

    (a) schemes should be viewed as legitimate alternatives to takeover bids (or other means of securing 100% ownership, such as selective capital reductions) rather than as a mechanism to avoid them (in particular as they provide minority shareholders with forms of protection which are not provided by bids (such as Court supervision));

    (b) it would not be reasonable to attempt to draw a direct comparison between the 90% compulsory acquisition threshold and the 75% of shares voted threshold, as these measure different things and in different contexts (eg. the compulsory acquisition threshold measures the number of shares accepted into a bid over several months, at a minimum, whereas the scheme threshold focuses on the shares voted at one point in time at the scheme meeting), and transposing the compulsory acquisition test into a scheme process would effectively render the approval threshold impossible to satisfy in all but a (very) few unusual cases; and

    (c) the scheme provisions do not require revolutionary reform – that is, it's not broken so don't fix it.

23. It is important to recognise that, in practice, a 75% voted shares threshold in the context of a scheme meeting is a substantial threshold to meet, given the number of shareholders who vote at a scheme meeting will in most cases represent significantly less than 100% of the total votes held in the scheme company (ie, it is common for the proportion of shares actually voted to be in the range of 50% to 70% of total shares). In such circumstances, a 10-15% holding by a hostile shareholder (which, if voted, would represent a proportionately larger number of shares) may be sufficient to prevent a scheme being approved.

24. We note that the 75% of shares voted test is used in the context of a number of other important corporate actions, and no concern is raised to the threshold in those contexts.

Voting on cancellation schemes that include a capital reduction

25. The CAMAC Paper does not specifically discuss the additional voting requirements that apply to schemes that include a capital reduction. Nevertheless, AAR would like to take the opportunity to suggest a possible reform in this area.

26. Generally speaking, an acquisition by scheme can take one of two forms, namely, a 'transfer scheme' (under which the shares the subject of the scheme are transferred to the purchaser) or a cancellation scheme (under which the shares the subject of the scheme are cancelled). Market practice in recent years has tended to favour transfer schemes. However, there is no reason why cancellation schemes should be excluded from CAMAC's review and possible reform.

27. The CAMAC review provides an opportunity to clarify the issue of whether or not the consideration received under a cancellation scheme (which is technically provided by a third party, not the scheme company) ought to be treated as consideration that is received 'as part of the reduction' for the purposes of section 256C(2)(a). This issue is important because a cancellation of a share for no consideration is treated as a capital reduction but does not in fact reduce the company's capital to the potential detriment of creditors (and so neither the requirement in section 256B(1)(b) for there to be no material prejudice to creditors nor the duty of directors to prevent insolvent trading in section 588G apply).

28. ASIC could be given modification and exemption powers in relation to the capital reduction provisions in Part 2J.1, similar to those it has in relation to selective buy-backs (see section 256D) and Chapter 6 (and which we submit it should be given in relation to schemes, as discussed below). That way, ASIC could provide exemptions for cancellation schemes on a case by case basis where the voting requirements would otherwise give rise to anomalous outcomes. This would be similar to the practice that currently exists in the context of resolutions for section 611, item 7 approvals when all (or a majority) of shareholders would otherwise be prohibited from voting in favour of the resolution – there are numerous examples of ASIC giving relief in these circumstances by modifying item 7 to delete paragraph (a)(ii) so that all shareholders other than the purchaser (who is excluded by paragraph (a)(i)) may vote on the resolution.

29. Alternatively (or in addition), AAR submits that in such a scenario, the cancellation should be seen as a cancellation for no consideration (as it is a factual matter that no consideration flows from the scheme company itself), and so it is appropriate for sections 256B(1) (in particular section 256B(1)(b)) and 588G to have no application. This could be achieved either by way of a specific exemption to the requirements of section 256B(1) where the selective reduction occurs by way of a scheme, or amendment of section 256B.

Regulatory and judicial powers (CAMAC Paper, section 5)

ASIC exemption and modification powers (CAMAC Paper, section 5.1)

30. AAR supports ASIC being granted exemption and modification powers in relation to the scheme provisions. While this may arguably be unnecessary at the present time given that the scheme provisions are not as detailed and prescriptive as other areas of the Corporations Act, such powers would have an important role to play if any reforms resulted in additional prescription being introduced, as a 'one size fits all' approach may not be appropriate in all cases.

Section 411(17) (CAMAC Paper, section 5.2)

31. There are three separate but related aspects to the question of whether section 411(17) should be repealed:

- whether Chapter 6 'avoidance' ought to be a reason for a scheme to not be approved by the Court;
- whether there should continue to be an express formal role for ASIC to confirm that it has no objections to a proposed scheme if section 411(17)(b) is repealed; and

- whether the scheme provisions should require compliance with the Eggleston principles or any of the other principles or procedures in Chapter 6.

AAR's submissions on these issues are set out in turn below.

Chapter 6 'avoidance' – should section 411(17) be repealed?

32. AAR strongly supports the repeal of section 411(17) in its entirety. It also supports the introduction of a purposive statement to the effect that a scheme may be used to effect a transaction that could otherwise have been effected under Chapter 6.

33. As noted at the outset of this submission, in our view, it is now generally accepted within the business and legal communities that schemes are a legitimate alternative to Chapter 6 takeovers and it is therefore critical that our legal and regulatory regimes continue to treat both mechanisms as legitimate (albeit different) alternatives to effect control transactions. In this respect, we see no reason for the principle of Chapter 6 anti-avoidance in section 411(17) to be retained in any form.

34. We support a framework in which schemes continue to be seen as a legitimate form of transaction in their own right, and which offer their own forms of protection for shareholders, rather than being viewed as a mechanism by which Chapter 6 may potentially be 'avoided' (which implies some ulterior motive founded in bad faith).

35. Equally, there should be recognition that strict compliance with Chapter 6 is not always appropriate, and it is ultimately the right of disinterested shareholders to decide whether a proposal is implemented. For example, proposals which treat some shareholders differently from others or which involve collateral benefits, both of which are prohibited by Chapter 6, are permitted in schemes subject to classes being determined appropriately. In our view, this flexibility is entirely appropriate and there is no reason to see them as examples of Chapter 6 avoidance. If anything, these should be seen as examples in which an intending controller is limited in its choice of legitimate transaction mechanisms because it cannot proceed under Chapter 6 and so is 'stuck' with a scheme route. The fact that a scheme cannot be conducted on a hostile basis means that this inflexibility can be very important in practice.

A formal role for ASIC in the absence of section 411(17)(b)?

36. AAR considers that it is not strictly necessary for ASIC to continue to have an express formal role to replace section 411(17)(b) as ASIC already has standing to raise objections to a scheme if it chooses to do so. Equally, AAR would not object to ASIC being given a formal role to issue a 'no objection' letter (or advise the Court of its objections, as the case may be) at the second Court hearing.

37. ASIC has an express formal role under section 411(2) in relation to the examination of the proposed explanatory statement for a scheme before the first Court hearing. Further, a Court must not make an order convening a scheme unless it is satisfied that ASIC has had a reasonable opportunity to make submissions to the Court at the first Court hearing in relation to the proposed arrangement and explanatory statement (see section 411(2)(b)(ii)).

38. ASIC also has a general power to intervene at the second Court hearing, pursuant to its general powers under section 1330.

39. Accordingly, there is no doubt that ASIC has the right and power to intervene in relation to a scheme if it wishes (whether at the first or second Court hearings). The real question is whether the scheme provisions should expressly require it to make representations to the Court as to whether or not it has any objections. That is, should the Court have the benefit of ASIC's views in all cases, especially at the second Court hearing stage?

40. As noted above, in our view, an express role for ASIC at the second Court hearing is not strictly necessary. Presumably, if ASIC did not appear at the second Court hearing, the Court would take comfort from the fact that ASIC was notified of the second Court hearing and elected not to appear. ASIC should not necessarily have to confirm in writing that it has no objections and/or does not wish to appear.

41. Nevertheless, we anticipate that the Courts will in practice continue to look to ASIC to provide independent guidance as a form of comfort in exercising their general discretion as to whether to approve a scheme on fairness grounds. That being so, AAR can see legitimate scope for ASIC being given a formal role at the second Court hearing and would not object to this. AAR considers that if such a role is introduced, it should require ASIC to either:

    (a) issue a letter confirming that it has considered the proposed scheme and does not wish to appear (AAR considers that ASIC should not be required to make a positive statement that it has no objections, as in some cases it may be that ASIC identifies one or more minor issues which it considers to be immaterial or not of a nature that it wishes to raise in Court, but which may cause it to be uncomfortable in making an absolute statement that it has no objections); or

    (b) appear at the second Court hearing to make submissions to the Court as to any objections that it wishes to raise (ASIC should not be required to appear if it has no objections).

42. As it would be anomalous if ASIC could delay the process by refusing to issue a letter and also refusing to appear, if such an approach is adopted then if ASIC chooses not to appear then it should be taken to have no objections.

Compliance with the Eggleston principles or other Chapter 6 rules or procedures

43. AAR does not support the introduction of any requirement for schemes to comply with any of the rules or procedures in Chapter 6. This includes key rules such as:

- the 4 month minimum price rule (section 621(3));
- the rule that all offers must be the same (section 619);
- the prohibitions on escalators and collateral benefits (section 622 and 623) – in this regard, AAR wishes to take the opportunity to note that it considers that the prohibition on escalators in section 622 serves no useful purpose in practice (especially as it is so easily avoided) and ought to be repealed, and would submit that CAMAC should recommend this as part of its ultimate report; and
- rules on the effect of acquisitions outside of the 'bid period' (section 651A) and the prohibition on disposals during the 'bid period' (section 654A).

The rationale for this is simple: schemes are different from takeover bids and provide different (and in our view, no less onerous) protections – the most important being the class voting requirements – and so there is no need to include additional prescriptive rules in relation to such matters. Briefly, the protections include:

- minimum price: a prospective purchaser who purchases in the lead up to a possible scheme assumes the risk that the scheme company may insist on an equivalent (if not higher) price and that it may be required to proceed with a Chapter 6 bid (in compliance with section 621(3)) if a scheme cannot be agreed, and the duties of the scheme company's directors also offer protection;
- offers to be the same: protections that exist if offers differ between shareholders include the scheme company directors' duties to act in the interests of the company as a whole (rather than favouring particular shareholders) and the class voting rules;
- collateral benefits: protection for those shareholders who are not offered collateral benefits under a scheme is clearly afforded by the class voting rules; and
- acquisitions outside of the 'offer': protections include the 20% limit in section 606 and the fact that the acquisition of additional securities does not necessarily assist the prospective purchaser under a scheme given the class voting requirements (and as discussed below, the scheme company directors can regulate such acquisitions in any event if they consider this to be a material issue) – this can be contrasted with a bid under which acquisitions outside of the bid can assist the bidder to satisfy its minimum acceptance condition.

Further, the flexibility that schemes provide is a key reason why they are a useful and legitimate alternative to takeover bids, and this flexibility should not be reduced.

44. In any event, if the scheme company is concerned by any such matters, it can regulate them in the implementation agreement. In this regard, the fact that schemes can only be undertaken with the support of the scheme company's board (and that the fact that the board is in turn bound by statutory and fiduciary duties) is itself a form of protection for shareholders. This is therefore another reason why prescriptive rules based on Chapter 6 are unnecessary and inappropriate for schemes. This can be contrasted with a potentially hostile Chapter 6 takeover offer under which there would be no protections for shareholders in the absence of the prescriptive rules and procedures in Chapter 6 – this is simply not the case with a scheme.

45. AAR does not consider it necessary for the Court to be specifically required to have regard to the Eggleston principles in section 602 when considering schemes. However, if this approach is adopted, AAR considers that this should only be one factor that may be taken into account by the Court as part of its overall discretion and should not of itself be determinative. AAR does not support any requirement or directive:

- for the Court to not approve a scheme if it departs from the Eggleston principles (whether or not there is a 'good reason' for the departure); or

- for the scheme company (or the prospective purchaser) to make submissions to the Court on Eggleston principle issues in the absence of an objector (including ASIC) raising this is as a specific area of concern in a particular case.

Extension and simplification of schemes (CAMAC Paper, section 6)

Options and convertible notes (CAMAC Paper, section 6.1)

46. AAR does not consider it appropriate for holders of options or other convertible securities to participate as such in members' schemes. Such holders are simply not members. They can always choose to participate by exercising or converting before the record date if exercise or conversion is permitted under the terms of issue of the option or security.

47. AAR also considers that the current practice whereby a prospective purchaser can insist on having inter-conditional schemes for options and convertible securities in addition to the share scheme works effectively as a means by which a purchaser may seek to reach 100% ownership of all classes of securities.

48. However, AAR also considers that the treatment of holders of such securities as creditors is artificial and inappropriate. It is certainly the case that option holders are not creditors in the true sense of the word. Further, holders of convertible notes or other hybrid securities are not really creditors of the company in a control scheme context – although their securities may take the form of debt (or have certain debt-like features), the only reason the purchaser is seeking to acquire them is because they have the capacity to convert into equity – so treating them as creditors is artificial.

49. Accordingly, AAR submits that the scheme provisions should be amended so that:

    (a) they apply to any class of security (in the same way that a bid must be made for a class of securities), not just shares or securities that have 'membership' rights – though perhaps this should be limited to securities that are convertible into equity (so that pure debentures and debt securities are not covered);

    (b) in relation to voting on schemes that relate to securities other than shares, votes held by security holders should be determined by reference to the value of their securities, similar to the treatment in creditors' schemes under the current legislation; and

    (c) it is made clear that options are to be treated as one class of securities irrespective of whether there are different exercise prices, vesting rights or exercise periods/dates (that is, even if different prices are offered for different options, there should be no requirement for separate class votes so long as the same methodology (such as a Black-Scholes methodology) has been applied consistently across the various options to determine the value of the consideration in each case) – this would be similar in approach to ASIC's policy on classes of securities in Section C of RG159.

Managed investment schemes (CAMAC Paper, section 6.2)

50. AAR would support the scheme provisions being extended to apply to interests in managed investment schemes. There are numerous reasons for this - but in essence, the key is that there does not appear to be any good reason why schemes should only be available to companies when a material proportion of the market for securities comprises managed investment schemes (or 'stapled' groups which include a managed investment scheme as one component).

51. AAR would support the scheme provisions being extended to both listed and unlisted managed investment schemes. Given that schemes are voluntary mechanisms, if an unlisted managed investment scheme does not wish to use a scheme then it doesn't have to, but we see no reason why the choice and opportunity to pursue a scheme of arrangement should be limited to listed managed investment schemes.

Other aspects (CAMAC Paper, section 1.5)

Section 414 (CAMAC Paper, section 1.5.2)

52. AAR would support the repeal of section 414. The section is rarely used and does not appear to perform a useful function, and there does not appear to us to be any good reason to reform it or any demand in the market for such reform.

Contact details

53. Please contact any of the following if you would like to discuss our submission or have any queries in relation to it:

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