Submission to the Corporations and Markets Advisory Committee

Members' Schemes of Arrangement

Discussion Paper

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Introduction

This submission addresses the release of the CAMAC Discussion Paper on *Members' Schemes of Arrangement* (June 2008). Some of the suggestions that have been provided in this submission are of a policy nature and question the need to modify the Members' Scheme of Arrangement, a mechanism used for achieving structural change within a company or a corporate group.

If any of the responses require further explanation please contact Claudia Koon Ghee Wee at UNSW ASB School of Banking and Finance at c.wee@unsw.edu.au or Marina Nehme at the UWS School of Law at M.Nehme@uws.edu.au.

Academics involved in producing this response

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General Observations:

The discussion paper, *Members' Scheme of Arrangement* (June 2008), analyses the need to modify the Members' Scheme of Arrangement, a mechanism used for achieving structural change within a company or a corporate group.

The observation made in this submission can be summarised in the following manner:

- Schedule 8 Part 3 provisions need to be appealed. This needs to be done when repealing reg 5.1.01. The directors' recommendation and the expert report requirements need to be introduced in the statute.
- There is a need for greater regulatory guidance concerning supplementary disclosure.
- Schemes of arrangements should have their own regimes of liability and defences.
- Incorporation of "in the best interest of members" test into the "fair and reasonable" test and use the combined test for both bids and schemes.
- Courts should not have express powers in relation to predetermining classes of members in a scheme of arrangement.
- The Headcount should be abrogated. There should be one exception and that is in the case of companies limited by guarantee.
- ASIC's exemption and modification powers should remain the same.
- Section 411(17) needs to be modified to take into consideration the Eggleston principles.

Introduction

The move to review members' scheme of arrangement is very important because the procedure that leads to a scheme of arrangement has not substantially been modified since its introduction to the Australian system in the beginning of the 20th century. Accordingly, our laws may be archaic in relation to this area and may need revamping. This review of schemes of arrangement is a desired move to keep our legislation up to date and competitive with overseas systems especially in view of the financial crisis that is starting to manifest itself in the United States of America and that may expand all over the world.

It is crucial for Australia to have a competitive member scheme of arrangement because it is in times of financial difficulty that these types of scheme would be most popular. For instance, after the October 19, 1987 Black Monday when NASDAQ crashed, research has found a significant increase in same industry takeovers, stock-financed takeovers, size of acquirers, and market-to-book ratio of assets of acquirers in the after-crash period relative to the before-crash period.[1] After the Korean currency crisis in 1997, Korean government has urged their domestic blue chip enterprises to merge their principal businesses to strengthen their business structure

[1] Vijay Gondhalekar, Vijay and Yatin N Bhagwat, Yatin N., "Evidence on Takeover Characteristics and Motives in the Acquisitions of NASDAQ Targets following the Stock Market Crash of 1987" (2000), EFMA 2000 Athens, University of Michigan Working Paper.

and profitability.[2] In Asia, during the financial crisis, cross border mergers and acquisitions were very popular. Such cross border mergers and acquisition in five countries in Asia during that peris reached a record level of US$11 billion in 1998 and US$15 billion in 1999. Before the crisis in 1996, the amount was US$2.6 billion.[3]

Accordingly, if the current global crisis reaches Australia, possibilities of mergers and acquisitions (especially cross border mergers and acquisitions) will be abundant and we need to have a competitive system in place to allow such transactions to go forward. Further, even under normal circumstances, many acquisitions are carried out through scheme of arrangement. The Financial Services Institute of Australasia noted that 'in the last 5 years, nearly 40% of all large (greater that $1 billion) change-of-control transactions have been carried out as schemes of arrangement'.[4]

Chapter 3: Information to shareholders

Possible changes to facilitate effective disclosure of scheme information to shareholders, including in relation to the content and method of disclosure:

The current disclosure system in relation to scheme of arrangement is cumbersome and needs to be in compliance with s 412 of the *Corporations Act* 2001 (Cth), reg 5.1.01 and Schedule 8 Part 3 of *the Corporations Regulations* 2001 (Cth).

The adequacy of the information given to shareholders is to be assessed by the court in a practical and realistic way.[5] For instance, Emmet J noted the following:

> The explanatory memorandum is substantial. It contains extraordinarily detailed information and material relating to the financial position and business of AMP and its subsidiaries, including projections as to the position following the demerger of AMP, on the one hand, and HHG, on the other. I have been taken by senior counsel for AMP to the significant aspects of the explanatory memorandum. It has not been possible, nor is it appropriate, for the court to examine the whole of such a complex document in detail. However, I am satisfied that the scheme that has been propounded by AMP is appropriate to be put before the shareholders of AMP for their consideration.

Such complexity may mean that mum and dad investors will not be able to understand and assess the impact of the explanatory statement made for the purpose of a scheme of arrangement. For this reason, there is a need to introduce a 'clear, concise and effective' requirement for the explanatory statement. This may assist shareholders to understand the scheme proposal on which they are asked to vote. This will also be in compliance with the courts requirement in relation to the disclosure documents. As

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[2] Hee-Jin Kang, Hee-Jin and Almas Heshmati, Almas, "An Evaluation of Korean M&A Policy in the Post-Currency Crisis", (2007) 3(1) ICFAI Journal of Mergers & Acquisitions (2007), Vol. III, No. 1, pp. 21-42.

[3] James Zhan and Terutomo Ozawa, *Business Restructure in the Asia: Cross Border M&A in the Crisis Period* (2001),11.

[4] Financial Services Institute of Australasia, *Takeover Package* (2006) 18, <http://www.finsia.com/Content/NavigationMenu/Media_centre/Mediareleases/2006archive/Takeovers_package_0406.pdf > viewed on 23 September 2008.

[5] *Re Crusader Ltd* [1996] 1 Qd R 117.

noted in the CAMAC discussion paper, Austin J observed that ''it is more useful… to give a concise and clear summary of the effect of the changes which is materially comprehensive.'[6] This is especially needed in case of complex disclosure document.

We agree with Damian and Rich that the Schedule 8 Part 3 provisions need to be appealed. This needs to be done when repealing reg 5.1.01. The directors' recommendation and the expert report requirements need to be introduced in the statute.

Further, we also agree that that the information should be lodged with ASIC and the shareholders should receive a brief roadmap of that information, together with reference to a website where the full information is available.

This has a number of benefits:

- The shareholders would be able to receive a summary of the important information. This will make it easier for mums and dads investors to understand the proposal. If they need more information, they can access the documents online.

- This may reduce the cost of scheme of arrangement.

- The use of the internet is welcomed. It is more environmentally friendly and it also maximise the use of technology available at our disposal. There is a need to rely more and more on the technology that is easily available to society. While doing so, it is of importance to assess the number of people who have access to such technology. The Australian Bureau of Statistic gathered the following information:[7]

Business Use of Information Technology, Summary Indicators - 2002-03 to 2005-06

	2002-03	2003-04	2004-05	2005-06
Computer use (%)	83.0	85.2	88.6	88.8
Internet use (%)	71.4	74.2	76.8	81.3
Web presence (%)	23.0	25.1	26.7	29.8

As it can be noted, the level of use of information technology is rising over time. In 2005-2006, 81.3% of the businesses are using the internet in one form or other. This number is bound to increase in the coming years. This empirical data supports the authors' anecdotal evidence of the use of the internet in the commercial world.

- More and more discussion is related to the need for the introduction of the use of internet disclosure. For instance, CAMAC's discussion paper on external administration referred to a number of options that related to online disclosure in the case of voluntary administration.

[6] Re Mirac Ltd (1999) 32 ACSR 107, 112.
[7] Australian Bureau of Statistics, "Business Use of Information Technology 2005-2006".

Further the court has allowed for notices of meetings of scheme of arrangement to be sent electronically.[8] Such a move is important and illustrates that the importance of the internet in our day to day life. The law in relation to scheme of arrangement should allow notice in relation to the scheme to be sent electronically. This would be in accordance with s 249J(3) and (3A) that permit notice of meeting to be send electronically.

Whether there should be greater statutory guidance concerning supplementary disclosure

We agree with Damian and Rich proposal in relation to this matter. There is a need for a clear regime in relation to supplementary disclosure. The new regime may note that the company that is subject to the scheme of arrangement must first approach ASIC (not the court) before releasing supplementary information. We do not believe that the court should be involved at the time of the issue of the supplementary information. In case of irregularity, the court may take such irregularity into consideration during the second hearing.

Whether the required standard for formulation of an expert's opinion should be more consistent between bids and schemes (Section 3.4)

We are of the view that the required standard for formulation of an expert's opinion should be more consistent between bid and schemes.

The issue arises from the seemingly different requirements for expert opinion under bids and schemes. For bids, s 640(1) of the Corporation Acts 2001 requires expert opinion "that states whether, in the expert's opinion, the takeover offers are ***fair and reasonable*** and gives the reasons for forming that opinion". On the other hand, for Schemes of Arrangement, Schedule 8 Rule 8303 of the Corporations Regulations 2001 requires expert opinion to state "whether or not, in his or her opinion, the proposed Scheme is in the ***best interest of the members*** of the company the subject of the Scheme and setting out his or her reasons for that opinion". Regulatory guidance for the definitions of "fair"[9] and "reasonable"[10] are given in ASIC Regulatory Guidance 111:

RG111.10:

> Under this convention, an offer is '***fair'*** if the value of the offer price or consideration is equal to or greater than the value of the securities the subject of the offer. This comparison should be made assuming 100% ownership of the 'target' and irrespective of whether the consideration is scrip or cash. The expert should not consider the percentage holding of the 'bidder' or its associates in the target when making this comparison. For example, in valuing securities in the target entity, it is inappropriate to apply a discount on the basis that the shares being acquired represent a minority or 'portfolio' parcel of shares.

[8] *Re Alinta Ltd (No 2)* [2007] FCA 1378.
[9] ASIC Regulatory Guide 111 RG 111.10
[10] ASIC Regulatory Guide 111 RG 111.12

RG111.12: When deciding whether an offer is ***reasonable***, an expert might consider:

(a) the bidder's pre-existing voting power in securities in the target;
(b) other significant security holding blocks in the target;
(c) the liquidity of the market in the target's securities;
(d) taxation losses, cash flow or other benefits through achieving 100% ownership of the target;
(e) any special value of the target to the bidder, such as particular technology, the potential to write off outstanding loans from the target, etc;
(f) the likely market price if the offer is unsuccessful; and
(g) the value to an alternative bidder and likelihood of an alternative offer being made.

On the other hand, there is no statutory or regulatory definition of the term "in the best interest of members". The definition of "best interests of the members" seems to be derived from the term "fair and reasonable"[11]; and the basis of evaluation selected by the experts must be appropriate to the nature of the specific transaction. A summary diagrammatical illustration of the relationship between the terms "fair and reasonable" and "best interests of the members" is given in Diagram 1.

This issue is further complicated by the contradicting interpretations on whether "fair and reasonable" is equivalent to "best interest of the members". Current legislation does not provide clear guideline by which the term "in the best interest of members" is to be evaluated. A review of current experts' reports revealed that the term "fair and reasonable" is considered to be equivalent to "best interest of the members" in current industry practice; yet in some instances these two terms are interpreted differently, leading to the view that the legislative test for Schemes differs from that applicable to a Chapter 6 takeover bid.[12] Some researchers[13] have commented that ASIC holds the view that "fair and reasonable" is to be equated with "in the best interest of members". However, upon closer examination of ASIC Regulatory guide, it seems that the "fair and reasonable" term is only equivalent to "in the best interest of members" term under two opposing situations – when the transaction is considered to be either "fair and reasonable", or when it is "not fair and not reasonable". In other words, when the transaction is "reasonable but not fair"[14], the term "fair and reasonable" does not equate "in the best interest of members".

According to ASIC Regulatory Guide 111, Schemes have to be in the "best interest of the members".[15] Whether a transaction is "in the best interest of members" can be implied from the "fair and reasonable" test if the transaction is entirely

[11] ASIC Regulatory Guide 111 RG111.15-111.19
[12] S E K Hulme QC, "Section 640 of the Corporations Law: Independent Experts' Reports and the RTZ Ltd Takeover of Comalco Ltd" (2001) 19 C&SLJ 134 at 143-4; Shears v Chisholm [1994] 2 VR 535 at 600-602
[13] For example, McDonald, L., Moodie, G., Ramsay, I., and Webster, J. (2003), Experts' Reports in Corporate Transactions, The Federation Press, at p.59; and Damien, T., and Rich, A. (2004), Schemes, Takeovers and Himalayan Peaks – The Use of Schemes of Arrangement to Effect Change of Control Transactions, Freehills Publication, at p.127
[14] ASIC Regulatory Guide 111 RG 111.14
[15] ASIC Regulatory Guide 111 RG111.17-111.19

"fair and reasonable" or "not fair and not reasonable". If a transaction is "reasonable but not fair", experts have to proceed to explain whether the transaction is in the best interest of the members. It is possible for a transaction to be "reasonable but not fair" yet still is in the best interest of the members if the consideration does not equal to or greater than the value of the securities the subject of the scheme, yet there are sufficient reasons for security holders to vote in favor of the scheme in the absence of a higher offer.[16]

To complicate the issue further, the words "fair and reasonable" in s 640 is not regarded as a compound phrase,[17] meaning that it is possible for an offer to have a split assessment for being "reasonable but not fair".[18] Below is a summary chart in regards to expert report for Schemes in accordance to ASIC Regulatory Guide 111:

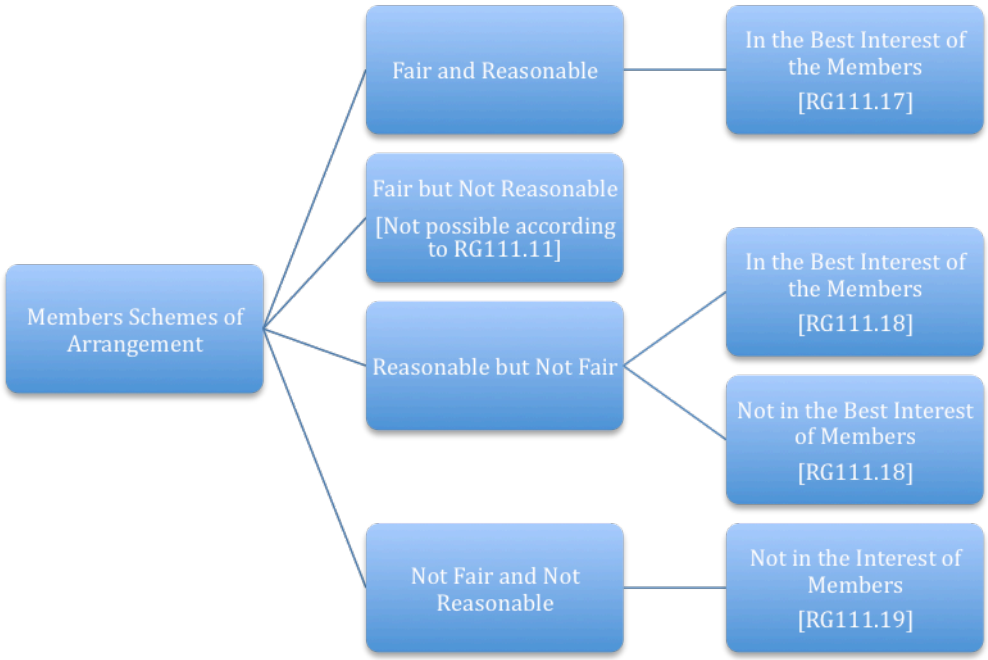

Diagram 1: The Relationships between "Fair and Reasonable" and "Best Interests of Members" under Members Schemes of Arrangement

Under the Schemes, it appears that the "best interest of members" test is redundant (though the correct wordings are still required) except when the transaction is "reasonable but not fair". If bids and Schemes are truly functionally comparable (with the exception to hostile takeovers), then experts should only focus on the purpose and outcome of the transaction, and not be made to tailor their wordings to suit either bids or Schemes – as suggested in ASIC Regulatory Guide 111 RG 111.4 "… An expert should focus on the purpose and outcome of the transaction, that is, the substance of the transaction, rather than the legal mechanism used to effect the transaction."

[16] ASIC Regulatory Guide 111 RG111.18
[17] ASIC Regulatory Guide 111 RG 111.9
[18] ASIC Regulatory Guide 111 RG 111.14

We suggest the incorporation of "in the best interest of members" test into the "fair and reasonable" test and use the combined test for both bids and Schemes. To a large extent, how the "fair and reasonable" test is currently interpreted is rather open-ended[19], hence either its statutory or regulatory definition should be further clarified to reduce the potential variable interpretation. Intuitively, it makes sense to consider a transaction as "fair and reasonable" only if it is in the best interest of the members of related companies.

Whether the liability and defences for disclosure breaches for schemes should be similar to those for bids

We agree with Damian and Rich proposal in relation to this matter. It is anomalous for scheme of arrangement not to have its own regime of liability in relation to misleading and deceptive conduct. As mentioned in CAMAC's discussion paper, Takeover, fundraising, financial services and product disclosure documents have their own disclosure regime. Similarly scheme of arrangement should have stand alone liability and defences. The due diligence defence should be introduced for scheme of arrangement defective disclosure documents.

Further, s 1041H(3) should be amended to exclude the application of this section to schemes of arrangement. It should note:

> 'Conduct:
>
> (a) that contravenes:
>
> (i) section 670A (misleading or deceptive takeover document); or
>
> (ii) section 728 (misleading or deceptive fundraising document); or
>
> ***(iii) Part 5.1 (misleading or deceptive scheme of arrangement documents)***
>
> (b) in relation to a disclosure document or statement within the meaning of section 953A; or
>
> (c) in relation to a disclosure document or statement within the meaning of section 1022A;
>
> does not contravene subsection (1). For this purpose, conduct contravenes the provision even if the conduct does not constitute an offence, or does not lead to any liability, because of the availability of a defence.'

[19] McDonald, L., Moodie, G., Ramsay, I., and Webster, J. (2003), Experts' Reports in Corporate Transactions, The Federation Press, at p.64

Chapter 4: Voting on Schemes

Class Voting:

First hearing:

Damian and Rich proposal in relation to giving the court express power, at the first court hearing, in relation to the composition of classes or relevance to the voting process of extrinsic interest. We do not agree with such a proposal. Even though it has some benefit in relation to adding certainty to shareholders meeting, it may diminish the flexibility of the scheme of arrangement. Further shareholders may not have a reasonable opportunity to be heard on an application to a court for a binding determination on class composition at the first hearing.

Additionally, ASIC's RG 142 (at [44]) notes that ASIC ensures when looking at the scheme documents that the determination of classes for voting is fair and equitable between those classes having regard to their rights and obligation. This may protect the interest of different classes of shareholders.

Second Hearing:

We agree with Damian and Rich proposal that the court should be given express curative power at the second hearing.

Intending controller:

We believe there is a need to clarify the position of an intending controller. It may be a desired to incorporate in the statute a section that is based on RG 142 [at 46]. Intended controllers should be required to fully disclose their interest and should not be allowed to vote in favour of the resolution to approve the scheme.

The headcount test as it applies to companies limited by shares, including the various policy options to retain, modify, dispense with or replace this test

We support option 4: Dispense with the headcount test. The 50% Headcount test is inconsistent with the economic precept underpinning the Corporations Act (one vote= one share). Further, it may create an incentive for 'share splitting'. We also agree with the law Council's argument for abolishing the headcount test.

The headcount test as it applies to companies limited by guarantee

Limited by guarantee companies should have special provisions that may allow headcount test to be conducted in scheme of arrangements.

Chapter 5: Regulatory and judicial powers

Whether there should be some change to the ASIC exemption and modification powers in regard to schemes

There is no justification to change ASIC's exemption and modification powers in regard to schemes.

However such power is given to ASIC, an appeal from ASIC's exercise of those powers should be to the Administrative Appeal Tribunal and not the Takeover Panel. Clear distinction need to be set between a takeover and members scheme of arrangement. They are not the same and the takeover panel should not have a say in relation to this matter.

Whether changes need to take place in relation to s 411(17)

We agree with George Durbridge to amend s 411(17) to explicitly incorporate the Eggleston principles for change of control schemes; and we agree that the court should not approve a takeover Scheme if it departs from the Eggleston principles without a good cause. We also are of the opinion that ASIC's 'no objection' statement power should be retained or enhanced to protect shareholders of the relevant companies.

It is of upmost importance that shareholders' protection is upheld and fairness of transaction has been ensured in any bids or Schemes condition, in order to promote a safe environment for future investors to invest. If s 411(17) was repealed, ASIC's role in reviewing Schemes would greatly diminish, signifying a loss of shareholders' protection.

Chapter 6: Extension and simplification of schemes:

No comment

Conclusion:

In conclusion, we are of the view that mergers and acquisitions increases shareholders' wealth by ensuring companies' competitiveness in various aspects. Threat of mergers and acquisitions protect shareholders from mismanagement of a company since they allow alternative management teams to compete for the control of the company's assets; hence reduces the potential monitoring costs shareholders have to pay to monitor managers' performance due to asymmetric information; and at the same time motivates managers to perform better to maximize shareholders' wealth.

Considering the role of mergers and acquisitions in promoting Australian financial and economical wellbeing, any modification of current legal and financial system that does not hinder the progress towards cultivating a more competitive mergers and acquisition should be encouraged, provided that

stakeholders' interests are well protected. It is also financially and economically intuitive to design a legal system that provide ample protection to shareholders, since ruthless takeovers activities can shake the very core of a country's financial stability. Australian financial market will become more competitive and attractive to both domestic and international investors if the processes of any potential mergers and acquisitions have been made more efficient.

26 September 2008