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Australia's takeover rules: how good are they?

Is Australia's takeover legislation in line with world best practice?

ELAINE HUTSON looks at takeover regulation in Europe, UK, North America and Japan and makes some comparisons.

The debate in Australia over freeing up takeover regulation is occurring against a backdrop of increasing recognition around the world that a well-functioning takeover market is essential to the efficient allocation of resources and overall economic prosperity.

The merits of a vigorous takeover market have long been understood in Britain and the US, and are being increasingly appreciated in countries where takeovers have traditionally been anathema—including most of continental Europe and Japan. Policymakers around the world are taking steps to remove regulatory barriers to takeovers.

The Corporate Law Economic Reform Program (CLERP) (1998), which was passed by the Senate in October 1999, included important changes to Chapter 6 of the Corporations Law (now the Corporations Act) regulating takeovers. However, one important pillar of takeover reform that had been in the bill—the mandatory bid or follow on rule—was scrapped as a result of Labor opposition.

The mandatory bid rule would have allowed potential acquirers to purchase a block shareholding greater than the current threshold of 20 percent, as long as such a purchase was followed by a bid for all remaining shares.

In an article published in the Winter 2000 issue of JASSA, I argued that Australia's takeover regulation overemphasises target shareholder protection, to the detriment of the efficient functioning of the market for corporate control.

Potential bidders may be deterred from proceeding with acquisition plans because the cost of compliance and low takeover threshold make acquisitions

unattractive. A mandatory bid rule would loosen up takeover regulation in Australia.

Global takeover practices

The world's regulatory systems for corporate control can be divided into two types: those based on the British system (including France and Germany) which combine a relatively high control or share ownership threshold (30–50 percent) with mandatory full bids beyond the threshold; and those based on the US system (including Canada and Japan) which combine a low threshold (5–10 percent) with the allowance for partial bids.

Australia's takeover regulation is a uniquely restrictive hybrid of these two systems. Comparison of the alternative systems with the Australian regulation suggests that the mandatory bid rule would go a considerable way to bringing it more into line with world practice.

Arguments against the mandatory bid rule

Labor opposed the mandatory bid rule on the grounds that it would disadvantage target shareholders by allowing potential acquirers to gain control of targets before a formal takeover bid. In particular, Labor argued that it would discourage competitors from emerging in the takeover process, inhibiting the 'auction' of a target company and thereby lowering the price paid to target shareholders.

The notion that target management should conduct an auction of the target company is not a feature of most regulatory regimes. It is unique to US takeover law, and applies only in a very limited set of circumstances. (This facet of the US regulatory system is described on page 36.)

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Ironically, a mandatory bid requirement is normally thought of as being a device for protecting the rights of minority shareholders. In the British system, it operates by requiring an offer to all shareholders when control is transferred. In Europe, where corporate law traditionally does little to safeguard small shareholders, the mandatory bid rule is seen as the ultimate in minority protection.

The need for balance in takeover regulation

Corporate control regulations were first introduced in Australia, Britain, Canada and the United States in the 1960s, but were not widespread in Europe until the late 1980s and early 1990s.¹

In the early days of takeover regulation there was an emphasis on the protection of minority shareholders. The main economic argument for minority protection is that it plays an important role in preserving the integrity of capital markets by enhancing the willingness of small shareholders to invest in equity. Without minority protection there may be insufficient interest in equity investment, resulting in depressed share prices and a sub-optimal allocation of resources.

If regulations overemphasise the protection of target shareholders, however, potential bidders might be reluctant to launch takeover bids because they are too costly and uncertain. Many commentators have questioned the need for rigorous 'protection' of target shareholders.²

The economic arguments against target shareholder protection are, first, that target shareholders are the consistent 'winners' in corporate takeovers, earning large excess returns.³ Second, capital markets are highly liquid, allowing investors to 'vote with their feet' and sell their shares, and well-established risk-management techniques such as portfolio diversification reduce shareholders' exposure to the specific risks of individual firms.

As well as protecting target shareholders, therefore, takeover regulation must enhance, or at a minimum, not impede, the market for

corporate control. Best practice takeover regulation should provide a balance between these two competing aims. Recognition of the importance of this balance is lacking in Australian takeover regulation.⁴

Australia's corporate control regulations

Chapter 6 of the Corporations Act (2001) regulates the conduct of takeovers. The underlying philosophy of protecting target shareholders is set out in the so-called 'Eggleston Principles'. These were enshrined in the Companies (Acquisition of Shares) Act (1981)⁵ (the forerunner of the current takeover rules), and are now encapsulated in Chapter 6 of the Corporations Act (section 602).

There are two primary methods of acquisition in Australia: the off-market bid and the on-market bid. An off-market bid allows the consideration to be in the form of cash or securities or a combination of both, and conditions can be attached to the bid. The on-market bid is a cash-only, on-market, unconditional bid for all voting shares. A third permitted takeover method is known as the 'creeping takeover', whereby 3% of the voting shares in a company can be acquired in any 6-month period.

Partial bids are extremely rare in Australia because pro-rata partial bids were disallowed in 1986. The pro-rata partial bid is so called because acceptances must be pro-rated if the bid is oversubscribed. For example, if the bid is for 40% of voting shares, and acceptances are received for 80%, then each shareholder may only sell half of his or her shareholding to the bidder.

The current allowable method of partial acquisition (section 618(1)(b) of the Corporations Act) is the proportional partial bid, where the bidder specifies the proportion of each shareholder's holding that it wishes to acquire. For example, if the bid is for 50% and acceptances are received from shareholders holding 50% of voting shares, then the bidder will only gain control of 25%.

Proportional partial bids have not been popular⁶ because bidders bear too

much outcome risk. If, for example, the bidder wants to purchase 40% of shares, it would be advisable to bid for a greater proportion because it is unlikely that all shareholders will accept. Bidders would face the risk of obtaining too many acceptances, and they could face financing difficulties as a result.

The British model

Takeovers in Britain are regulated by the City Code on Takeovers and Mergers (commonly referred to as the London Code), which was introduced in 1968. The London Code is administered by the Panel on Takeovers and Mergers (the Panel), which is a self-regulatory body comprising professionals from business and the securities industry.

The overall aim of the Code is to encourage the observance of general business standards, rather than requiring the parties involved to follow a series of binding regulations. The Code's philosophy is contained in its initial statement of ten general principles, which provide a balance between target shareholder protection and the efficient operation of the takeover market.

The most important shareholder protection principle is that if a bidder wishes to acquire effective control of a company, it must also move to statutory control by making an offer to all shareholders (the mandatory bid requirement). There are strict controls on the target company which prevent management and directors from taking action that results in the offer being frustrated. The Code has been held up as a model of good takeover regulation by many economic and legal commentators around the world. This is because of its flexible approach, its ability to act quickly in takeover disputes, and its impartiality and consistency in decision-making.⁷

The takeover threshold is set at 30% of voting shares, and there are few exceptions. Partial bids are discouraged. Before a partial bid can be launched, consent must be obtained from the Panel, which will normally give consent for partial bids up to 30% of shares (by definition, these bids are not

control-oriented). [French, 1986c: 258]. The partial bid rules are consistent with the Code's underlying principle that if a bidder wishes to acquire effective control, it must also move to statutory control by making an offer to all shareholders.

The EU's proposed takeover Directive

A draft takeover Directive⁸ first appeared in 1989. It was based on the London Code and included the mandatory bid requirement as well as controls on target management to prevent the use of takeover defences in the course of hostile takeover bids. Widespread disagreement over its terms led to the EU putting it on the 'back burner' for several years.

A revised draft was issued in February 1996 that aimed to establish a series of general principles instead of specifying detailed rules. The mandatory bid rule was still its centrepiece, but rather than stipulating the takeover threshold (set at 33% in the first draft), Member States would be able to set their own threshold. There remained, however, several areas of disagreement that delayed ratification of the Directive, the most contentious being the provisions relating to takeover defences.

A breakthrough occurred in early 1999, and by April 1999 the European Commission published a proposal that seemed to satisfy Member States. As a compromise on the defensive measures issue, the draft was amended to allow the target board to increase its share capital during the bid period.

Other defences, however, were to be disallowed except with the prior approval of shareholders. Unfortunately, however, the Directive suffered another two years of delay because of a dispute between Britain and Spain over who was entitled to designate a supervisory authority for Gibraltar!

On 27th April 2001, just two months before the planned European parliament vote, the German Government reversed its support for the Directive over the defences issue. Many commentators attributed this U-turn to the upcoming general election (which was due by September 2002), and concerns

amongst the German people about the acquisition of German assets by foreign companies. German members of the European parliament (MEPs) joined forces with several Italian and Spanish MEPs to defeat the Directive. The vote, on 4th July 2001, was lost on the narrowest possible margin: it was tied with 273 in favour, 273 against, and 22 abstentions. The Directive is once again being renegotiated.

Rejection of the Directive can be traced solely to the issue of allowable defences. The British position is that managers should not be permitted to defend against takeover bids unless shareholders have granted prior approval. While Germany is the only country to have come out publicly against the Directive in the final vote, it is widely believed that others, particularly Italy and Spain, want more scope for target management to defend against unwanted takeover bids. There will probably need to be more concessions on the issue for the Directive to be finally ratified.

Germany

Germany introduced a self-regulatory system of takeover regulation in 1979. By the late 1980s, these regulations were considered unsatisfactory, and following the release of the proposed EU Directive in 1989, Germany set about revamping its takeover rules. A takeover code based on the EU's proposed Directive was launched in 1995. This system was voluntary, however, and towards the end of the 1990s was widely considered to have failed: only 16% of the cases triggering the mandatory bid rule during 1995 to 1998 had actually made a mandatory offer [Thoma, 1998].

The legislative rules governing takeovers that are now in place were enacted on 1st January, 2002. There is a mandatory bid requirement with the threshold set at 30%. Partial bids for control are disallowed. Consistent with Germany's opposition to the anti-defensive provisions of the draft EU Directive, the legislation permits target management to defend against unwanted takeover bids by increasing share capital, repurchasing shares, and selling important assets.

Such defences are expressly forbidden in most regulatory systems around the world. Thus while the German legislation offers target shareholders protection in the event of a successful takeover bid, the allowable defences make it more difficult for bidders to succeed in hostile takeovers. This makes it less likely that takeovers will be launched in the first place.

France

The first takeover law in France was introduced in 1989. Following a series of contentious hostile bids, these regulations came to be seen as inadequate, and in November 1998 new regulations based on the draft EU Directive were introduced. The amendments involved major changes to the mandatory bid provisions by reducing the compulsory bid threshold from 50% to 33% except in the case of block acquisitions, where the threshold remains at 50%.

A provision similar to the Australian 'creeping bid' was also introduced, whereby the compulsory bid requirement is waived as long as the shareholder does not acquire 2% or more of the target's voting shares in any 12-month period.

As with the British and German systems, the mandatory bid rule precludes partial bids for control.

In summary, therefore, the main distinguishing feature of the British model of takeover regulation is the mandatory bid rule.

The rule is designed to protect minority shareholders by requiring that once a bidder has acquired control of a company, it must move to statutory control by making a full bid for all remaining shares.

This principle is the centrepiece of the EU's proposed takeover Directive, it is the main feature of takeover regulation in its three largest states, and it is gaining acceptance throughout the EU.

Although the EU takeover Directive has not yet been ratified, the remaining debate is confined to allowable takeover defences rather than to the underlying philosophy inherent in the mandatory bid rule.

The US model

Takeover regulation in the US is a

complex amalgam of Federal and state laws. In its jurisdiction over securities matters, the Federal government regulates tender offers. Company law, however, is state-based, and mergers are consequently regulated by state law. State laws also affect the tender offer process through the states' jurisdiction over corporations. Many states allow anti-takeover amendments to corporate charters, or have specific anti-takeover legislation in place. In addition, as a result of the extensive litigation that has been associated with takeovers in the US, there is also a considerable body of case law.

Tender offers are regulated by the Securities Exchange Act (1934), which is overseen by the Securities Exchange Commission (SEC). Section 14(d) of the Act prescribes procedures and rules for the conduct of tender offers, but it does not define a threshold point beyond which a takeover bid must be launched.

In practice, however, it has become 5% as this is the threshold at which 14(d) comes into operation. There are no mandatory bid requirements under US Federal law. Partial bids are permitted as long as acceptances are pro-rated in the case of oversubscription of the tender offer (rule 14d-6).

Many states, however, allow companies to amend their corporate charters to prevent partial bids. For example, some have 'fair price provisions' which prevent successful partial bids being followed by a second bid at a lower price.

Another example is a law applying in the State of Delaware, where over half of the US's top 500 companies are based [Gaughan, 1991: 88]. The law requires that a bidder who acquires more than 15% of the target company's shares cannot complete the takeover unless 85% of the stock is acquired, or the shareholders approve the acquisition by a two-thirds majority.

Facilitation of 'auctions'?

The US common law has developed such that in certain circumstances target company directors are required to conduct an 'auction'. This issue first arose in the 1985 case *Revlon Inc. v. MacAndrews and Forbes Holdings* (Revlon). When takeover entrepreneur

Ronald Perelman launched a tender offer for Revlon, the board countered with a management buyout of its own, to which they granted special privileges.

The directors were later forced to withdraw due to conflicts of interest, but the buyout group remained the favoured bidder. The Revlon directors decided in favour of the buyout group, but the resulting action in the Delaware courts was resolved in favour of Perelman. The judge's reasoning was that the role of the board had changed:

"The Revlon board's authorisation permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximisation of the company's value at a sale for the stockholders' benefit... The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." [cited in Herzel and Shepro, 1990: 101].

Confusion resulted amongst takeover law specialists as to when an auction is required. The issue was clarified in the case *Paramount Communications Inc v. Time Inc* in 1990:

"Under Delaware law there are, generally speaking...two circumstances which may implicate Revlon duties. The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganisation involving a clear break-up of the company. However, Revlon duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction also involving the breakup of the company." [cited in Herzel and Shepro, 1990: 99-100].

The general principle is that the duty to conduct an 'auction' is likely to be triggered when the directors face a conflict of interest, or when some action of the directors signals the abandonment of its long-term strategy or its likely breakup. It is certainly not required in most cases.

Canada

Like Australia's takeover law, the Canadian regulations derive from both the British and US systems. I categorise Canada under the 'US model' because, as in the US system, there is no mandatory bid requirement and pro-rata partial bids are permitted. The Canadian constitution provides for companies to be established under either provincial or federal government. The best known of the provincial bodies regulating companies is the Ontario Securities Commission, whose rules tend to be followed by the other provinces.

Under Ontario law, a takeover bid must be launched when the shareholding exceeds 20%. Federal law specifies 10%. There are several exemptions to this requirement, including stock exchange or over-the-counter bids (subject to conditions designed to protect shareholders), offers made to less than 15 shareholders, and control block transfers applying to holders of 20% or more of the target stock.

These exemptions make Canadian corporate control law considerably more flexible than Australia's. Canada also has an exemption similar to Australia's 'creeping takeover', whereby the purchase of less than 5% of shares within 12 months is permitted.

Japan

Japanese takeover law is based on the US tender offer system because post-war reorganisation forced the government to adopt the US Securities Act (1933) and Security Exchange Act (1934). As in the US, the tender offer regulations imply a 5% takeover threshold, and partial bids are permitted as long as acceptances are pro-rated.

In summary, the philosophy underlying the US approach to corporate control regulation differs from the British approach in that acquirers of American companies are not required to move to full share ownership once control has transferred. While in practice the system in the US is complex because of several (often overlapping) jurisdictions and extensive use of the courts in setting disputes, the overriding principle is quite simple.

Takeover bids must be launched at quite low shareholding levels, but

acquiring companies have the opportunity to limit the costs of the acquisition by making partial bids.

Implications for Australia

This paper has documented the major features of takeover regulation in Britain, Canada, France, Germany, Japan and the United States. Australia's system of corporate control regulation is arguably the most restrictive in the world. The Australian regulations specify a low triggering threshold but do not allow pro-rata partial bids.

In the British model, the mandatory bid rule allows the purchase of a controlling stake in advance of the formal takeover bid, thus limiting the uncertainty faced by the bidder.

The inability for bidders in Australia to acquire greater than 20% in advance of a takeover bid means that takeover bids must be launched before the bidder holds a controlling stake, making takeover bids for Australian companies considerably riskier than in jurisdictions governed by the British model.

While US-style regulations have considerably lower takeover thresholds, pro-rata partial bids—which are much cheaper for the bidder than full bids—are permitted.

In the British system, the mandatory bid rule makes takeovers relatively expensive but minimises risk to bidders, while the US model trades off additional risk for lower cost.

In Australia, however, the current regulations make takeovers both highly risky and relatively expensive.

Target shareholders in Australia are very well protected once a takeover offer is under way. If inappropriate regulation is preventing takeover bids from being launched in the first place, however, the market for corporate control is not operating properly and all shareholders are the losers.

The proposed mandatory bid rule, which was removed from the CLERP (1998) due to Labor opposition in the Senate, would have eased Australian regulations and brought them into line with overseas trends.

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NOTES

1 Some European countries, notably the Netherlands, still have no formal takeover regulations.

2 Mannolini (1996) is an excellent critique of target shareholder protection provisions. In the US, the debate has centred on the equity of the 'two-tier' offer. See, for example, Comment and Jarrell (1987).

3 For a summary of the international and Australian evidence on this issue, see Hutson (1997).

4 The major reform to takeover law in the CLERP amendments that was passed by the Senate is the newly constituted Takeovers Panel. On evidence so far, the Panel seems to be working as it was designed—to take takeover disputes out of the courts. This removes at least one source of additional cost and potential delay to bidders.

5 For more information on the history of takeover law in Australia, see Hutson (1998).

6 Ramsay (1992) explains that in 1987, 1988, 1989 and 1990, partial bids comprised respectively 6, 5, 2 and 4% of total bids launched, compared to 40% in 1982.

7 For a more extensive discussion of the merits of the London Code and Panel, see Frazer (1988).

8 The takeover Directive is formally known as the 13th Company Law Directive. EU Directives are aimed at harmonising regulations amongst Member States, while allowing them to tailor those rules to suit country-specific requirements.

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