THE WHITE KNIGHT DEFENCE: CAN A TARGET COMPANY BE AN ASSOCIATE?

by

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Mr. Justice Needham's April decision in the recent Bond Corporation litigation against Campbells on whether a target company can be associated with one of its shareholders for the purposes of the Takevover Code is sure to provoke considerable comment amongst lawyers, merchant bankers and other advisers in the takeover arena because it flies in the face of published NCSC rulings and the conservative approach adopted by lawyers to the interpretation of the "black letter" law of the Takeover Code.

Bond Corporation Decision

On March 22, 1985 Bond announced a proposed takeover for Arnotts Limited.

On the same day but before Bond's takeover announcement, Arnott issued 5,565,301 shares to Campbells, increasing Campbell's interest in Arnotts from 4 per cent to approximately 10 per cent. Arnotts also announced its support for Campbell's application to the Foreign Investment Review Board to increase its investment in Arnotts to 25.1 per cent, and invited two of Campbell's executives to join the Arnott's Board of Directors.

Bond immediately commenced action in the Supreme Court of New South Wales seeking interim orders restraining Campbells from acquiring any further voting shares or disposing of any voting shares in Arnotts and restraining Arnotts from registering any transfer of Campbell's voting shares in Arnotts.

Bond based its case on a breach by Campbells of the Takeover Code. Bond argued that in taking up the issue of shares by Arnotts, Campbells breached the prohibition in s11(2) of the Takeover Code which provides that a person (Campbells) who is entitled to more than 20 per cent of the voting shares in a company (Arnotts) can not acquire more shares in the company unless the acquisition is permitted by the Takeover Code. Permitted acquisitions include acquisitions pursuant to a takeover offer or a takeover announcement or purchases of 3 per cent of shares every 6 months.

Clearly Campbells would not breach the prohibition in s11(2) if regard was only had to its direct shareholding because the allotment only resulted in its direct shareholding increasing from 4 per cent to approximately 10 per cent well below 20 per cent; therefore Bond alleged that Campbells was entitled to those shares Arnotts was entitled to in itself.

Bond alleged:

(a) that prior to the issue to Campbells, Arnotts through its shareholding in Allied Mills had a "relevant interest", within the meaning of section 9(1) of the Takeover Code, in 19.44 per cent of its issued capital.

(b) that Arnotts was an "associate" of Campbells under s7(4) of the Takeover Code; and

(c) that Campbells breached section 11(2) of the Takeover Code because the issue of shares to Campbells resulted in its "relevant interest" in shares (including the interest of its associate) increasing from approximately 24 per cent to 28.3 per cent.

Thus the Court had two questions to answer:

* Is Arnotts an "associate" of Campbells?; and
* Does Arnotts have a "relevant interest" in its own shares?

Mr. Justice Needham did not consider the second of these two questions, because he dismissed Bond's claim that Arnotts was an associate of Campbells.

In order to determine whether Arnotts was an associate of Campbells, Mr. Justice Needham considered each of the paragraphs of section 7(4) of

the Code[1] relied upon by Bond Corp. and rejected each of Bond's submissions. Needham J's comments in relation to s7(4)(c) illustrate the judge's approach to the question of association.

In simple terms s7(4)(c) says that Arnotts would be an associate of Campbells if Arnotts in concert with Campbells is acting, or proposes to act, in relation to the acquisition or proposed acquisition of shares in Arnotts. Needham J. said that in his opinion this view of s7(4)(c) was "illusory" because Arnotts cannot be twice referred to in this paragraph. That is Arnotts cannot be an associate in respect of its own shares.

He said:

> If the legislature had intended that what might be called the target company could be one of those persons aiming at the target, it could have used more acceptable language than it has used in section 7(4)(c) . . . It could quite simply have said that a "person" may include the company whose shares are the subject matter of the acting in concert. The fact that there are three entities mentioned in the paragraph with every indication of separateness tell strongly against the plaintiff's submissions.

Is Mr. Justice Needham's decision correct? If he is correct then, subject to other common law and statutory considerations in relation to the allotment of shares in a target company, he has given the directors of a target company a strong weapon in defending an unwanted takeover bid.

It is suggested that Needham J's decision is not correct because the alternative interpretation of the section better promotes the purpose of the Takeover Code and thus should be accepted.

View of "Association" Prior to Bond Corp. Case

Before the Bond decision there had not been much judicial consideration of the question of "association", let alone the question of whether a target company could be an associate of an acquirer of shares. In the only decided case[2] on the meaning of s7(4) Mr. Justice O'Bryan said:

> A wider use of English language to define the word "associate" would be hard to imagine.

Later on in that case O'Bryan J. said:

> Consistently with the views I have expressed regarding the construction of the definition of "relevant interest" I consider one should give a literal construction to the definition of "associate". It is for Parliament to narrow the meaning of ordinary words it has used in a statute by inserting further words. The intention of Parliament appears to me to require a wide meaning to be given to the definition of "associate" having regard to the language used in the Statute as a whole.

A wide interpretation of "associate" has always been advanced by the NCSC. Part of the NCSC's October 1982 enquiry into the acquisition of shares in Grace Bros. Holdings Ltd. was directed towards determining whether Grace Bros. and its directors were associated with Savona and its directors. This enquiry was held to determine whether the NCSC should declare acquisitions of shares in Grace Bros. as "unacceptable acquisitions" under s60 of the Takeover Code because one of the principles enunciated by the Eggleston Committee (discussed below) had not been met.

Although the NCSC ultimately held that as a matter of fact the evidence was too tenuous to warrant proceedings under the Code based upon an allegation of the existence of an association it did make some interesting observations on the meaning of association for the purposes of the Code:

> 39 where a person is contemplating an investment in a company and is supportive of the board of directors or a control bloc, the question of whether or not an association is created becomes a very fine one.
>
> 42 However, the situation may change when further elements are added ... [if] the support of a substantial shareholder is likely to have a significant effect on the continued incumbency of a board of directors of the policies they apply in the affairs of the company, then an acknowledgement by that investor of support for that board at a critical time, coupled with discussions between him and a representative of the board which may encourage the investor to hope for future participation in some aspect of the conduct of the affairs of the company (even though there is no reference to a specific project) may be enough to give rise to an "association" within the meaning of the Act. This is because it is sufficient to render the members of the board of directors associates of a person if the person proposes to become informally associated with them with a view to influencing the composition of the board of directors or the conduct of the affairs of the company.

This quotation is interesting because the NCSC is not saying that the target company can be associated with a substantial shareholder, but rather that the board of

directors of a target company can be associated with a substantial shareholder. Is there a difference?

A company must act through living persons, though not always the same person. Lord Denning put it this way:

> A company may in many ways be likened to a human body. They have a brain and nerve centre which controls what they do. They also have hands which hold the tools and act in accordance with directions from the centre. Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind and will. Others are directors and managers who represent the directing mind and will of the company, and control what they do. The state of mind of these managers is the state of mind of the company and is treated by the law as such.[3]

Following this principle, one view of what the NCSC is saying is that a target company through its *board of directors* can be associated with a shareholder in the company. If Mr. Justice Needham had considered this organic theory of corporate identity then he may have been prepared to accept that a target company could be associated with another person in the acquisition of shares of the company. That is, the company through its board of directors as the acting mind and will of the company could lead the company into an association with a person who was acquiring shares in the company. Explained in this way, Mr. Justice Needham's interpretation that each of the paragraphs of s7(4) of the Takeover Code requires three entities does not seem so acceptable.

Given that there are two competing interpretations of s7(4), that interpretation which promotes the purpose of the Code is to be preferred. Before looking at the purpose of s7(4) it is appropriate to note briefly what the High Court has said on the proper way to interpret statutes.

Proper Approach to Statutory Interpretation

Justices Mason and Wilson of the High Court of Australia in *Cooper Brookes (Wollongong) Pty. Ltd.* v. *FCT*[4] had this to say about statutory interpretation:

> The fundamental object of statutory construction in every case is to ascertain the legislative intention by reference to the language of the instrument viewed as a whole. But in performing that task, the courts look to the operation of the statute according to its terms and to legitimate aids in construction . . . the propriety of departing from the literal interpretation is not confined to situations described by these labels. It extends to any situation in which for good reason the operation of the stature on a literal reading does not conform to the legislative intent as ascertained from the provisions of the statute, including the policy which may be discerned from those provisions.[5]

Purpose of Takeovers Code

There is no doubt that Mr. Justice Needham's view on the question of whether a target company can have an association with another person is open on the words of s7(4). However, there is an equally forceful view, adopted by the NCSC and by many takeover advisers, that it is possible for an acquirer of shares in a target company to be associated with the target company.

If it is assumed that there are two equally forceful interpretations of s7(4) that interpretation which is upheld should be the one that gives effect to the legislative intention of the section in the context of the Takeover Code as a whole.

The search for the proper legislative intent of the section is a necessary part of the correct interpretation of a provision of the Takeovers Code because the existence of s5A(1) of the Companies and Securities (Interpretation and Miscellaneous Provisions) (New South Wales) Code which provides that in the interpretation of the Takeover Code a construction which promotes the purpose or object underlying the Code (whether the purpose or object is expressly stated in the Code or not) is to be preferred to a construction which does not promote that purpose.

What is the purpose of the Code? It is generally agreed that the basic purpose of takeover legislation in Australia was first proclaimed in February 1969 by the Eggleston Committee (otherwise known as the "Company Law Advisory Committee to the Standing Committee of Attorneys — General"). The Committee stated in its second interim report that:

> There appears to be general agreement that some regulation of takeovers is necessary to ensure fair treatment of shareholders. At the same time, looked at from the point of view of investors, it cannot be said that takeover bids are disadvantageous . . . In making the recommendations which follow, we have not been actuated by any desire to discourage the making of takeover bids in cases where the safeguards for the protection of shareholders are observed . . . We agree with the general principle that if a natural person or corporation wishes to acquire control of

> the company by making a general offer to acquire all the shares, or a proportion sufficient to enable him to exercise voting control, limitations should be placed on his freedom of action so far as is necessary to ensure —
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> (i) that his identity is known to the shareholders and directors;
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> (ii) that the shareholders and directors have a reasonable time in which to consider the proposals;
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> (iii) that the offeror is required to give such information as is necessary to enable the shareholders to form a judgment on the merits of the proposal . . .;
>
> (iv) that so far as is practicable, each shareholder should have an equal opportunity to participate in the benefits offered

Because the Takeover Code has in its present form developed from the Eggleston Committee Report it is generally considered that this statement of the reasons for takeovers legislation in Australia underlines the purpose and objectives of the Takeover Code. To support this proposition one only has to look at the way s60 of the Code has been drafted. Under s60 the NCSC has the power to declare an acquisition "unacceptable", however, it can only exercise this power if one of the four matters referred to by the Eggleston Committee has not been met.

In a recent decision[6] Mr. Justice Olney in an ex tempore judgment said of the purpose of the Takeover Code:

> I have reached the clear view that the evident purpose and objectives of the Code is to ensure that the shareholders of a target company receive the utmost protection and that they should not in any way be the subject of exploitation by the directors or other persons having control.

If the purpose of the Takeover Code is to control the acquisition of shares by a shareholder and its associates so that all the shareholders are fully aware of the identity of an acquirer of shares and are not subject to the exploitation of directors and other persons having control of the target company then the better interpretation of s7(4) is that a target company can be an associate of a person acquiring shares in the company. To do otherwise would too easily defeat the intention of the legislation by allowing the target company to be independently associated with various shareholders, thereby controlling the company.[7]

Mr. Justice Needham's failure to analyse the purpose behind section 7(4) is a major flaw in his approach to the proper interpretation of that section of the Takeover Code.

Conclusion

After Mr. Justice Needham's decision, Bond lodged an appeal which was to come before the New South Wales Court of Appeal on April 15, 1985. It was reported in the press that the appeal was to be deferred until Monday, April 22, 1985 in order to allow the NCSC to intervene. However, in the financial press on Monday, April 15, 1985 it was reported that Campbells had funded the purchase of Bond's holding in Arnotts and that Bond had agreed to withdraw its proceedings against Campbell.

Given that consideration of the questions raised by Bond will now not be decided on appeal, what is the state of the law in Australia on this question? Although it is suggested that reliance should not be placed on Needham J's decision it may assist in a defence to a contravention of s11 by a target company and its associates. It is a defence to a contravention of the prohibition on acquiring shares above 20 per cent in a company if it can be established that the contravention was due to inadvertence or mistake or by not being aware of a relevant fact or occurrence.

In the light of the decision in the Bond case it may be possible for a defendant accused of a breach of this prohibition, because of his association with the target company, to argue that the breach occurred due to a mistake of law, that is, reliance on Mr. Justice Needham's decision. In a recent decision[8] Chief Justice Burt of the Supreme Court of Western Australia said in relation to a defence of a mistake of the law raised in respect of another section of the Takeover Code that:

> . . . a belief based upon the law as decided by a competent court would seem to me to be based on reasonable grounds and it would remain so based notwithstanding the fact that after the statement was served or given or the offer dispatched the decision was over-ruled by a superior court.

However, if the Commission has its way, this defence will not be available for too long as the NCSC proposes an amendment[9] to the Takeover Code to eliminate a mistake of the law as a defence to a breach of the Takeover Code.

In the meantime, if a target company is prepared to accept the possibility that the NCSC may declare an allotment to a shareholder during the course of a takeover bid as "unacceptable" under s60 of the Code, and subject to any other common law and statutory

considerations, a target company may want to rely on the Bond decision in defending an action for a breach s11. However, in the black letter world of the Takeover Code conventional wisdom suggests that strong reliance should not be placed on Mr. Justice Needham's decision in the Bond case.

Footnotes:

1. Sections 7(3) and (4) of the Code read as follows:—

"7(3) [Entitlement to shares] For the purposes of this Code, the shares in a company to which a person (in this sub-section and sub-section (4) referred to as the "person concerned") is entitled to include —

(a) shares in which the *person concerned has a relevant interest*; and

(b) except where the person concerned is a nominee corporation in respect of which a certificate by the Commission is in force under sub-section (8) or under the provision of a law of a participating State or of a participating Territory that corresponds with that sub-section — shares in which a person who is an *associate* of the person concerned *has a relevant interest*.

7(4) [Associated persons for purposes of s.7(3)(b)] A reference in paragraph 3(b) to a person who is an associate of the person concerned shall be construed as a reference to —

(a) if the person concerned is a corporation —
  (i) a director or secretary of the corporation;
  (ii) a corporation that is related to the person concerned; or
  (iii) a director or secretary of such a related corporation;

(b) a person with whom the person concerned has or proposes to enter into, an agreement, arrangement, understanding or undertaking, whether formal or informal and whether express or implied —
  (i) by reason of which either of those persons may exercise, directly or indirectly control the exercise of, or substantially influence the exercise of, any voting power attached to shares in the company referred to in sub-section(3);
  (ii) with a view to controlling or influencing the composition of the board of directors, or the conduct of affairs, of the company referred to in sub-section (3); or
  (iii) under which either of those persons may acquire from the other of them shares in the company referred to in sub-section (3) or may be required to dispose of such shares in accordance with the directions of the other of them;

(c) a person in concert with whom the person concerned is acting, or proposes to act, in relation to the acquisition or proposed acquisition of shares in the company referred to in sub-section (3);

(d) a person with whom the person concerned is, or proposes to become, associated, whether formally or informally with a view to controlling or influencing the composition of the board of directors, or the conduct of affairs, of the company referred to in sub-section (3);

(e) a person with whom the person concerned is, by virtue of the regulations, to be regarded as associated in relation to the acquisition or proposed acquisition of shares in the company referred to in sub-section (3);

(f) a person with whom the person concerned is, or proposes to become, associated, whether formally or informally, in any other way in relation to shares in the company referred to in sub-section (3); or

(g) if the person concerned has entered into, or proposes to enter into, a transaction, or has done, or proposes to do, any other act or thing, with a view to becoming associated with another person as mentioned in paragraph (b), (c), (d), (e) or (f) — that other person.

Rendoel Pty. Ltd., submitted that Arnotts was associated with Campbells by reason of s7(4)(b)(i), (ii) and (iii), 7(4)(c), 7(4)(d) and 7(4)(f). Needham J. rejected this submission.