THE GOOD AND BAD OF BUY-BACKS

NEW RULES DON'T SOLVE ALL THE PROBLEMS

by JOHN M. GREEN

Despite moves on various regulatory fronts, the treatment of share buy-backs by public companies remains susceptible to broad interpretations.

In the days following the October 1987 market crash, about 1,000 US companies were engaged in buy-back schemes or announcing their intention to do so. The companies spent tens of billions of dollars.

In the week of the crash, 25 per cent of the US Standard and Poor's 500 companies bought back their stocks, representing up to 6.5 per cent of total volume on the New York Stock Exchange. The buy-back trading in some of those companies was up to 80 per cent of their own volume.

The US Securities and Exchange Commission (SEC) found that the prices of buy-back companies' shares decreased less during the market slump than those of non-buy-back companies. Even companies which had announced buy-back schemes, but not yet implemented them, outperformed the S & P index by 80 per cent. The index itself moved positively after buy-back announcements.

The SEC found that these purchases appeared to be made for legitimate business purposes, based on geniune belief that the stocks were undervalued and were a good buy.

Current reform

In Australia, new legislation governing buy-backs recently became effective. But under the legislation – and new rules introduced by the Australian Stock Exchange (ASX) – questions and difficulties remain.

Before the changes, section 129 of the Companies Code prohibited a company, directly or indirectly, from:

- financially assisting acquisitions of shares or "units of shares" in itself or its parent;
- in any way actually acquiring shares or units or shares in itself or its parent;
- in any way lending money on the security of shares or units of shares in itself or its parent.

Sub-section 129 (10) provided a useful and often-used mechanism for giving such financial assistance if the company has 75 per cent shareholder approval and, effectively, declarations of solvency by the directors. However, the sub-section did not apply to permit acquisitions themselves.

Section 36 of the Companies Code prohibits a company from becoming a member of its parent, and makes void the acquisition of shares or units of shares in its parent. If, when it becomes a subsidiary, a company already has shares or units of shares in the parent, it must dispose of them within 12 months; until disposal, those shares lose their votes.

"Units of shares" are any rights or interests in a share and include an option to acquire any such right or interest. What, then, about convertible notes and listed options (i.e., options over unissued

John Green is a partner in Freehill, Hollingdale and Page. This is an edited version of his address in October to an Adelaide companies and securities workshop arranged by the Monash University Centre for Commercial Law and Applied Legal Research.

shares)? What if you are a listed company and your shares and convertible notes are trading below par or redemption value? Can you buy them under the new code, or under the current ASX rules?

Poseidon case – a loophole?

In *August Investments v. Poseidon*, a 1971 South Australian decision, it was held, sensibly, that where a company makes a bid for or buys another company, and that target company has shares in the bidder/acquirer, the bidder/acquirer is not illegally purchasing its own shares. Two important features should be noted about Poseidon.

First, it was a case in which the bidder shares owned by the target were not a large part of or its sole assets. (It was somewhat similar to Wormald's 1987 bid for Sunshine which, through a subsidiary, owned 23 per cent of Wormald.) Indeed, Justice Mitchell in the Poseidon case referred to what would happen if the assets of the target comprised solely shares in the acquirer. Courageously for 1971, she thought a court would be entitled to look at the "realities of the situation". Of the three judges, she was alone in expressing that view.

Second, the prohibition then being considered was section 67 of the Companies Act 1961, of which section 129 is the beefed-up wunderkind. Section 67 only prohibited "purchasing" or "dealing" in shares; Section 129 prohibits "acquiring" shares. Further, section 129 speaks about doing so "directly or indirectly". Section 67 did not. It only prohibited "direct or indirect" financial assistance, not acquisitions.

In some recent buy-backs, the Poseidon case has been used to support those parts of the deals involving the purchase of companies the sole assets of which were shares in the acquirer. None has been tested.

Note also *Dyason's* case (1935 Victorian decision) where B and C were the only shareholders in A. A bought shares in B. The court found A did not "directly or indirectly purchase. . . its own shares".

Australian Stock Exchange

On July 1, 1988, the ASX listing rule 3V on buy-backs came into operation. Changes to the rule took effect on July 1, 1989. In essence, under the rule, listed companies can only engage in buy-backs if the following conditions are met:

- securities must be purchased on-market and "in the ordinary course of business", or through proportional offers to all shareholders (i.e. , no selective buy-backs, even if 100 per cent of shareholders agree);
- only fully paid ordinary shares can be bought (except for NL companies) – no options, partly paids, or preference shares (redeemable or not) can be bought back;
- convertible loan securities can be bought back freely with none of the following restrictions, provided they are not converted after purchase and are cancelled;
- only 10 per cent of the class can be purchased under the scheme;
- a special resolution of shareholders must approve the purchase;
- a special resolution of unsecured loan security holders must approve it – but not option-holders;
- directors must confirm the scheme would not result in insolvency;
- price is limited to 5 per cent above average of prior-five-day closing trades for on-market purchases;
- shares are cancelled within 12 months, meanwhile, no sale or re-issue;
- voting rights of the shares are suspended;
- purchases are disclosed next day to the market and in the company's annual report;
- the scheme is suspended on a takeover bid by or for the company;
- the scheme is suspended on a new issue decision;
- directors cannot sell into a buy-back scheme;
- vendor securities cannot participate in buy-backs;
- the scheme is limited to a life of 12 months.

The ASX rule creates difficulties. It speaks of "company buy-backs" but does not define them.

Under existing law, it appears lawful for companies to buy back their debt instruments, e.g. convertible notes. Since the crash many companies have done so as a method of cheap funding. That was prohibited by the ASX, but the July 1989 changes fixed that.

Even though there is a requirement for all loan security holders to approve a scheme, optionholders' approval is not required. Optionholders are treated as poor cousins.

The rule applies also to property and equity trusts which do not have any current legal impediment from buying back units, except in their trust deeds.

Directors cannot participate in a buy-back. But if it is required to be only by on-market, ordinary-course trading, how can a director know he or she is selling to the company and not to someone else?

If it is *pari passu*, why should he or she be stopped from selling? That rule is effectively nonsense and incapable of sensible application.

The ASX has introduced the concept of the "satellite" of a listed company, to catch the various structures used to avoid the legal proscriptions under pre-Code law. A "satellite" is a company or "entity" which in the opinion of the ASX "has a common purpose" with a listed company for purposes of the buy-back scheme rule. Is there a common purpose if the listed company's sole purpose is to fund the satellite and leave it to the satellite to decide if it will embark on a buy-back or not? For the satellite, is the taking of the funds a purpose or merely a means?

How can the listing rules stop a satellite which is neither controlled by the listed company nor listed itself? They cannot. Or is the only remedy suspension of the listed company? How appropriate is that? It may not be in all cases.

Because the ASX seems to regard employees as "associates" or "satellites", there was also a massive conflict between the ASX buy-back rules and those for employee share schemes. If the employee share scheme involves the purchase of shares, not just an issue, it is apparently a buy-back and, generally, will be stopped by the ASX unless it complies with listing rule 3W.

In December, 1988, listing rule 3J(32)(b) was introduced. It prohibits selective reductions of capital, regardless of shareholder approval and court supervision. This, too, will need to be watched if you want to do a buy-back.

The conflicts between the ASX rule 3V and 3J(32)(b) and the new code will lead to trouble. Note that the new code provisions override the ASX rules.

Shareholder action

This is the New Wave of corporate warfare. Perhaps the apparent new-found outspokenness of the institutions in the post-crash environment will accelerate this trend. There are various possibilities. These include:

- to seek a declaration or injunction that the proposed buy-back, in an appropriate case, was unlawful – i.e., to seek a determination of the application today of the Poseidon case;

- to seek a declaration or injunction that the new code has not been complied with – section 574;
- to stop a shareholders' meeting or invalidate a decision of such a meeting if the directors, when recommending a course of action, fail to give full and fair disclosure of all material information. So the message, if a shareholder meeting is called, as required under the ASX listing rule and the new Code, is to examine carefully what the shareholders are told;
- to seek access to the company's documents under s.265B of the Companies Code, a section permitting shareholder access to corporate records for proper purposes;
- to use section 42 of the Securities Industry Code to enforce the ASX listing rules. Check that they are satisfied. But what of conflict with the new code?

Issues which should be considered in any shareholder action against a buy-back (and indeed by directors in proposing or conducting one) include directors' duties to both shareholders and creditors, Takeover Code restrictions, questions of insider trading and market-rigging, tax liabilities and accounting treatment.

At least 16 Australian companies had, before the introduction of the new code, announced or conducted buy-backs. To the extent that they were legal, they demonstrate the inadequacy of the existing legal prohibition. To the extent that they were *not* legal, they demonstrate the inadequacy of our enforcement agencies and the historical unwillingness of shareholders to complain – or, alternatively, commercially they were sound deals.

Shareholder approval was not sought in all cases. In some, it was sought only on the financing issue, not on the "purchase" itself; in some, because of ASX rule 3J(3); in some, because of what seem to be "warm-inner-glow" reasons; and in some because the method adopted was a reduction of capital. Some examples of buy-back activity follow.

Armada Resources. In late 1987, post-crash, Armada set up a 50/50 joint-venture company, with funding from Armada, with shareholder approval under section 129(10) to permit the JV Company to acquire Armada shares.

As the JV Company was structured so as not to be a subsidiary of Armada (see section 7 Companies Code), JV Company was not prohibited from either acquiring shares in Armada (sections 36 and 129) or keeping them (section 36).

There may be a question as to whether Armada's section 129(10) lifebuoy resolution was valid. It approved future, but unspecified, acquisitions up to $15 million worth with a maximum price of 60 cents. Section 129(10) requires particulars of proposed acquisitions to be given. Ask if these are "proposed acquisitions" and, if so, if the necessary particulars have been given.

What about directors' duties in buying at any particular time? The fact of shareholder approval will not eliminate the risk on a subsequent purchase if the motive for it is at that time bad – e.g., a takeover defence. Ask, though, if a similar structure to Armada is used, whether the JV Company's directors who make the decision to buy can have purposes in that capacity which in their capacity as target directors would be improper?

And also, are these 50/50 structures really non-subsidiaries?

AFP. AFP has done two buy-backs. In early 1988, associates of Mr Abe Goldberg made a takeover bid for Linter. The offers were either cash or less cash plus one AFP share for each Linter share. AFP group owned 30 per cent of Linter's fully paid shares and 41 per cent of its fully diluted capital.

AFP desired that its two Linter-share-owning subsidiaries accept the Goldberg offer, choosing the cash-and-AFP-share alternative. To do so, it proposed at a shareholders' meeting in May 1988 that the "top" subsidiary, the capital of which was two fully paid ordinary shares and one million redeemable convertible preference shares, issue to another, but non-AFP, company, two ordinary shares at par.

In effect, the subsidiary became a joint-venture company similar to the Armada JV Company (indeed, using the same joint-venture shareholder). However, the company did not use the Armada Section 129(10) route, but the simpler APA route (see below). Here, because of the preference shares, the full economic value of the investment would stay with the AFP Group.

The Armada Section 129(10) route was unnecessary as there was no real question of AFP financing the acquisition of AFP shares, unless one gives an especially strained interpretation of Section 129. However, AFP did seek and obtain shareholders' approval.

The second attempt was simply that AFP proposed that Elders' shares in AFP be cancelled. Elders was to be paid less per share than either market or net asset value. This was to be done either by a reduction of capital or a scheme of arrangement. ASX refused, citing listing rule 3J(32)(b) and saying, in effect, this was a selective buy-back. It later relented.

Elders IXL. Elders has done two buy-backs, one for preference shares, one for ordinary shares. The schemes are similar.

Elders had on issue 100 million 10-cent cumulative participating redeemable preference shares, issued at $1 and redeemable on June 30, 1992. These were issued under a rights issue announced in May 1985. Elders wished to redeem them early, but as that was not practicable, decided to acquire an interest in them. It proposed that an Armada-style joint-venture company buy these shares.

The scheme was that Elders lend up to $130 million to Henry Jones (IXL) Limited, Henry Jones (IXL) on-lent those funds to Henry Jones Investment Limited, and it, in turn, subscribed for preference shares in a joint-venture company, Prefvest, so that Henry Jones had two of the four ordinary shares and up to 13 million of $10 preference shares (1 cent par and $9.99 premium). The same independent investor as in the Armada and AFP schemes was to hold the two other ordinary shares.

Prefvest was permitted to acquire the Elders preference shares by any of four methods:

- on-market purchases where the maximum number and price would be announced two business days prior to the purchases. Prefvest's broker would stand in the market on that basis for not less than two weeks;
- offers under the Takeover Code to all preference shareholders;
- pro-rata partial offers for a specified number of preference shares (the Takeover Code has banned such offers for cases where it applies);
- a tender invitation similar to that used by IEL for Rothmans.

In its on-market offer, Prefvest is limited to a price formula, but not in the other methods.

But, how can Prefvest, in the second method, make offers regulated by the Takeover Code unless these shares are "voting shares"? It would seem they are, based on their voting rights, although this is very technical. If so, Prefvest can, if it makes a takeover bid for them, and reaches 90 per cent of them, compulsorily acquire the balance – even if the holders were unwilling.

Would preference shareholders who are also ordinary shareholders vote for such a scheme if they were aware of that possibility? Would directors of Elders be acting properly to even agree to Prefvest compulsorily acquiring shares from Elders shareholders against their will?

The preference shareholders were not given the opportunity to vote on the scheme. Were they entitled to that right? The rights of the shares allow them to have the exclusive right to vote on any proposal which "directly or indirectly effects any of their special rights or privileges". Does this proposal? It would seem no, although if compulsory acquisition were a prospect, would it then?

If they are voting shares, how can Prefvest use the third method and make pro-rata partial offers for them without breaching the Takeover Code? It can do that provided their acquisition would not increase anyone's entitlement to Elders shares in breach of section 11 of that code. No doubt Prefvest would be careful at the time to ensure that did not occur.

Similar considerations apply to the fourth option (the IEL/Rothmans tender).

The scheme had a December 31, 1989 sunset clause, unless there is a further shareholder approval.

Interestingly, at any time on or after June 30, 1991, Henry Jones Investments can convert any of its Prefvest preference shares into Prefvest ordinary shares. If only done for one such share, Prefvest would then become an Elders subsidiary and Prefvest would be obliged to dispose of the Elders preference shares within 12 months of that. But they are redeemable on June 30, 1992, i.e., 12 months later.

Thus, if it so wished, Elders could consolidate Prefvest (and these shares, or their value, subject to proper accounting treatment) as at June 30, 1991, rather than have the Prefvest preference shares in its books at up to $130 million.

The scheme for the ordinary shares was similar in structure. The notes sent to shareholders say nothing about whether there are any applicable Takeover Code restrictions, and if so, how they apply to the scheme.

Pioneer. Pioneer purchased Neoma Developments Pty. Limited from Bell Group for $124.7m. Neoma owned only Pioneer shares – 6 per cent of them. Pioneer had also agreed to buy Bell's 7.2 per cent holding in Ampol, giving Pioneer 88 per cent of Ampol.

Further, clients of J. B. Were & Sons had bought on-market 10.6 per cent of Pioneer; 4 per cent of that was taken by Australian Cement Limited, a 50/50 joint venture with CSR (i.e., not a subsidiary of Pioneer).

No Pioneer shareholder approval was obtained. Of course, Ampol shareholder approval was obtained because of Pioneer's increase in entitlement to Ampol shares from 80.8 per cent to 88 per cent.

Was Pioneer's purchase of Neoma valid? What about directors' duties? Here it was easier (conveniently) for Pioneer's board as apparently Bell Group had stated it would not sell the Ampol stake unless Pioneer took the Neoma company.

The new Code is a very significant improvement in its approach to public company buy-backs.

It was notorious that Pioneer was keen to acquire the Ampol stake and that purchase would move it closer to achieving its object.

A Neoma-type structure must still be a high risk – but in my view better than BHP's Freeside deal, because Neoma existed to start with. The Neoma shares had to be disposed of within 12 months – whether by cancellation or otherwise. The Australian Cement shares do not carry the same constraints.

BHP. In January 1988, BHP, Elders and Bell announced the final peace plan, whereby BHP agreed to take the bulk of Bell's holding and sterilised Elders, at a cost of $2.7 billion.

- BHP bought Freeside Pty Ltd, a special-purpose company whose sole assets were 300 million BHP shares (19 per cent) – similar to Neoma/Pioneer;
- BHP subscribed for shares in Beswick Pty Ltd, giving it 49.99 per cent of the issued capital, Elders to retain 49.9 per cent and ANZ Trustees & Executors to take 0.01 per cent. Beswick had 18.9 per cent of BHP – similar to Armada, AFP, Elders, APA and Australian Cement;
- BHP agreed to sell its Elders shares to Harlin Pty Ltd and was to sell other assets worth $1 billion.

BHP, like Pioneer, has relied on Poseidon for the Freeside deal. It has now cancelled the Freeside shares.

For the Beswick component, there are also nice questions of legality. One is whether BHP's subscription for shares is financially assisting Beswick's acquisition of BHP shares. I suggest not.

APA. APA was an 88 per cent subsidiary of Unity Corporation. It engaged in three interesting buy-backs, two actual, one aborted. The first (and perhaps other two) was in the aftermath of the Humes debacle.

That bid was made by Unity APA, a joint venture vehicle of Unity and of APA. The Supreme Court ultimately required both APA and Unity APA to find buyers of the APA shares issued as consideration in the Humes bid.

This was done by Unity APA, which had previously been a subsidiary of APA, simply issuing more shares in itself to Unity to desubsidiarise itself from APA. Otherwise it could not have bought the APA shares. The NCSC gave an approval under the Takeover Code to do this. Subsequently the shares were cancelled on a capital reduction.

The second innovation was APA, 88 per cent owned by Unity, bidding for its parent. This was also achieved by APA desubsidiarising itself from Unity, not too difficult a task given that Unity's holding was held by a subsidiary of nominal capital.

Also, GPS, formerly a subsidiary of Stirling Properties, launched a bid for its parent. Some time before, GPS issued some shares under its employee share plan which had the result that it was no longer a subsidiary. Subsequently, prior to the actual bid, GPS announced the bid would not proceed, and Stirling acquired more shares in GPS which resubsidiarised it.

North Broken Hill-Peko. North Broken Hill Holdings had made a scrip bid for Peko-Wallsend in 1988. Peko held 9.8 per cent in North Broken Hill, among its other assets.

Elders Resources NZFP, already a North Broken Hill shareholder as well as a Peko shareholder, accepted the North Broken Hill offer, going to 21.9 per cent of North Broken Hill, and deeming through North Broken Hill under the Takeover Code, claimed the Peko 9.8 per cent as well. Peko became a wholly-owned subsidiary of North Broken Hill.

In November 1988, North Broken Hill announced a "restructure" which involved:

- the cancellation of the Elders NZFP 21.9 per cent for $444 million cash;
- the sale to Elders Resources NZFP of various assets for $310 million cash; and
- the placement of the Peko parcel of 9.8 per cent to institutional investors for $193 million. The placement was underwritten.

The North Broken Hill shareholders were asked to approve the restructure as a selective reduction of capital. This involved a section 123 special resolution, and court confirmation, together with an approval under ASX listing rule 3J(3) as Elders Resources NZFP, a substantial shareholder, was buying assets in excess of 5 per cent of shareholders' funds. The 3J(3) requirement required shareholders be given an independent expert's opinion.

The buy-back code

The new Code is a very significant improvement in its approach to public company buy-backs. It splits **direct buy-backs** into five permitted types – proportional, selective, on-market, odd lots and "employee" shares

The rules for the permitted direct buy-backs include:

- articles of association must include a buy-back power with a three-year maximum sunset;
- specific special resolution if not in the articles or if selective;
- specific ordinary resolution if a takeover proposal is looming;
- 10 per cent cap per year;
- only ordinary shares, fully paid or partly paid, are permitted;
- no preference shares are permitted. (Why? The ability to redeem cheaper than the eventual redemption value should be permitted. Note, current ASX rules only permit buy-backs of partly paids for NL companies);
- Options and convertible notes: specific provision for the purchase of these was originally made, subject only to solvency requirements. The new code, however, does not refer to them at all. Whether this is because of the view their acquisition is legal already is unclear. Note again, ASX 3V prohibits buy-backs of options, but allows buy-backs of convertible notes;
- no treasury stock – on the transfer of the shares being registered, they are automatically cancelled and cannot be sold or re-issued;
- no scrip offers or recapitalisations: the company cannot offer its own shares or other securities, so it cannot use buy-backs as a method of recapitalisation, unfortunately. But, there is no restriction on offering securities of subsidiaries, or other non-cash consideration;
- the company cannot make any rights issues or placements within three months either side of a buy-back. Beware, these time constraints include negotiation periods. Does this include bonus issues and shares issued under dividend reinvestment plans?
- any purchase price involving a premium above par is written-off against share premium account, and then distributable profits. Given the importance of share premium accounts, directors should be wary of shareholder complaints.

The provisions for **indirect buy-backs** are directed to cancelling the Poseidon loophole and the joint-venture structures used, usually together with a 129(10) resolution.

Section 129(10) has been changed to prevent it being used by companies to avoid the restriction on them indirectly acquiring their own shares. But query if this new 129(10)(m) actually works. For example, would it stop the Elders buy-back of ordinary shares?

The NCSC has been given a power to declare buy-backs unacceptable, similar to section 60 of the Takeover Code. This power has two basic thresholds before it can be used. The first is the 10 per cent relevant interest test. If after the scheme, the company will have (or is likely to have) a relevant interest in more than 10 per cent of itself, the first trigger is satisfied. The second is whether there is likely prejudice to the company, shareholders or creditors, having regard to "relevant matters".

The "relevant matters" are an extensive list, including the sufficiency of information available to members, creditors and the ASX, what opportunities exist to consider the scheme, whether the opportunity to participate was shared among members, the effect on actual or possible takeover, and the effect on the company's state of affairs.

Other buy-back issues include the probably illusory nature of the 10 per cent annual **cap** on volume. By careful use and timing of a combination of odd lot buy-backs, employee buy-backs, other direct buy-backs and some indirect buy-backs, it should be possible to buy back more than 20 per cent!

In seeking shareholder approval, the directors have to disclose whether they are aware of any "**proposal**" for someone to increase or obtain a "substantial interest" in the company. Those terms are undefined. "Substantial interest" is the same term as in Section 60 of the Takeovers Code. I am at ease with this term, though – what is substantial depends on the circumstances – that is good and leaves room for judicial discretion.

But what is a "proposal" to acquire a substantial interest? There is perhaps too much uncertainty here. Indeed, having regard to the Tavola and Southern Resources cases on similar language in ASX listing rule 3R, it could be fairly easy for directors to avoid disclosing expressions of interest, even strong ones, which do not amount to proposals.

New ASX Rules

Whatever the new rules are, they should be designed to limit market-rigging, so I would have rules restricting volume, timing, price and manner of purchases, similar to the US SEC's safe-harbour rule, together with extra disclosure both pre and post-acquisition:

Volume: to prevent the company dominating the market, the company may only effect daily purchases of up to 25 per cent of trading volume, being the average daily trading volume over the preceding month.

Timing: the company's purchases may not be the opening purchase or be made during the last half-hour before the close of trading. Opening and closing trades are apparently significant indications of current market value as they forecast direction of trading and suggest strength of demand.

Price: as under the existing Rule 3V.

Manner of purchase: through only one broker on any given day, to prevent the appearance of widespread interest in trading activity through the use of several brokers.

Disclosure: the company should disclose to the market prior to doing any on-market buy-back that it is doing so and should announce the results by no later than the opening of the following morning. □