MARK COLLINGE CARRUTHERS

PURCHASE BY A COMPANY OF ITS OWN SHARES

A COMPARATIVE ANALYSIS OF SELECTED ASPECTS OF THE NEW ZEALAND AND AUSTRALIAN LEGISLATIVE PROVISIONS

LLM RESEARCH PAPER
BODIES CORPORATE
(LAWS 523)

LAW FACULTY
VICTORIA UNIVERSITY OF WELLINGTON

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ABSTRACT

This paper subjects three transactions which are typical in the North American jurisdictions to critical comparative analysis in the New Zealand and Australian contexts to establish if each transaction is viable by the medium of a share buy-back. Problems which will be encountered are identified and analysed.

The three transactions analysed are:

(1) a buy-back agreement between shareholders and their closely held company

(2) a going private transaction by a listed company

(3) a systematic on-market repurchase programme by a listed company to arbitrage capital costs.

The text of this paper (excluding contents page, footnotes, bibliography and annexures) comprises approximately 21,000 words.

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PURCHASE BY A COMPANY OF ITS OWN SHARES

1. INTRODUCTION

This paper will discuss the 1887 case of Trevor v Whitworth[1] ,which is the genesis of the prohibition against the purchase by a company of its own shares and which, until recently, prevailed in all Commonwealth jurisdictions. The nature of buy-backs, and some of the purposes for which they can be used is then considered and an overview of the different approaches taken to share repurchases in New Zealand, Australia and the U.S.A. is undertaken.

The main body of the paper is devoted to a comparative analysis of the problems that the new share purchase regimes in New Zealand and Australia will present in the context of three particular types of transaction on each side of the Tasman.

The three particular transactions chosen for analysis are:

(1) a buy back agreement between shareholders and their closely held company

(2) a going private transaction by a listed company (including purchase of own shares as a takeover defence)

(3) a systematic on-market repurchase programme to arbitrage capital costs (i.e. monitoring and adjusting the debt to debt plus equity financing ratios (gearing adjustments)), or to stabilise the share price.

2. GENESIS OF THE PROHIBITION

The prohibition at common law against a company purchasing its own shares originated with the 1887 decision of the House of Lords in Trevor v Whitworth. In that case one of the principals of a company purchased (apparently as agent for the company) all of the shares of a deceased

1 (1887) 12 App Cas. 409 (HL)

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shareholder from the latter's executors for a price equal to the original issue price of the shares. The company's debt to the deceased shareholder's estate was to be paid over a period of 3 years with interest payable on the outstanding balance. Before payment in full was achieved, and due to trading losses, the company was wound up and the executors of the deceased shareholder sought to enforce against the company's liquidators the outstanding debt in respect of the share repurchase.

In the House of Lords it was decided that the principal of the company had purchased the shares not in his individual capacity, but as an agent of the company. All of their Lordships' judgments rested on the grounds that, firstly, a purchase by a company of its own shares was an unsanctioned way of avoiding the necessity to comply with the then current statutory formalities governing a reduction of capital, and secondly, that buying its own shares using the company's own assets, and in a manner not specifically authorised by a company's Memorandum of Association, was not a power that the company could claim and exercise, regardless of whether such a procedure was contemplated by the company's Articles of Association.

In the leading judgment, Lord McNaughton also considered whether such a purchase of own shares could be provided for in the company's Memorandum of Association. His Lordship rejected this view on the basis that such an authorisation could not sit beside the statement of fixed capital which appeared also in the Memorandum.

Three major policy lines can be extracted from the judgments in Trevor:

(1) the main policy justification was Their Lordships' perception that creditors would be put at considerable risk if unconstrained purchase by a company of its own shares was permitted:[2]

> Paid up capital may be diminished or lost in the course of a company's trading; that as a result no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely

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[2] Supra. n.1 423-424

> upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company have been subsequently paid out, except in the legitimate course of its business.

(2) a share repurchase was fundamentally opposed to the notion of a company as a legal entity with a fixed amount of capital which could only be increased or decreased as a result of its trading activities, or in compliance with the statutory scheme for capital reduction.

(3) repurchase transactions would constitute a method of influencing or subverting shareholders' respective rights, entitlements and liabilities in a way that could not necessarily be constrained by the corporate governance regime established by law and by the particular Articles of Association of that company.

The three grounds can thus be summarised as creditor protection, preservation of capital maintenance rules, and the prevention of the subversion of normal principles of corporate governance.

As can be seen from the above, the blanket prohibition on share repurchase arose in the context of a closely held company buying out a deceased shareholder pursuant to a buy-out agreement. Of the many potential problems associated with repurchase (i.e. trading in own shares, reduction of creditor protection, removal of opposing shareholders using the company's assets, and achieving capital reduction without following the set statutory formula), the only one of these potential abuses being litigated in Trevor was the unauthorised reduction of capital scenario.

That Their Lordships could have based their judgments on more limited technical grounds, but chose a more expansive approach, indicates they were clearly aware of the wide range of potential abuses, distortions of traditional principles of corporate control and misuse of the company's own

assets for purposes which may not be in the best interests of the company (as opposed to those of management and/or controlling shareholder/s) that a power of repurchasing own shares, using the company's (rather than any third party's) assets presaged.

The judgment was clearly intended to, and did, bury any notions of the legitimacy of self-purchase for a very long time. By basing their judgments on the three very wide principles identified above, their Lordships precluded the possibility of the case being distinguished in later cases and limited to its own particular facts.

3. NATURE AND PURPOSES OF SHARE REPURCHASES

(i) Nature

A share repurchase transaction is not limited in effect to sale by one party of its shares and the acquisition of those shares by the purchaser. As well as a change of ownership of shares, it will also act as a redistribution of assets from one party to another (cash and/or non cash consideration from the company to the selling shareholder in return for the repurchased shares), and will also alter ownership participation, and thus control of a company, except where the repurchase is offered and accepted in a pro-rata manner, so that each shareholder's proportionate ownership participation and (theoretical) share of control is preserved.

As a distribution of company's assets, a share repurchase transaction has the potential to work to the disadvantage of creditors, by removing from the company's pool of assets, which are available for distribution, a cushion of funds available to satisfy creditors' claims against the company. It does this by not only returning fully paid up capital (plus any premium over the original purchase price) to shareholders but also, in the case of a purchase of partly-paid shares, removes the pool of unpaid and uncalled capital which would otherwise be available to satisfy creditors' claims in the event of liquidation by the liquidator making a call on such partly-paid shares and collecting the capital for distribution.

So, as a mechanism for distribution of assets, the share repurchase transaction can threaten creditors by transferring those company assets otherwise available for the settlement of debts out of circulation and into the hands of the selling shareholders.

Because a share repurchase transaction most often functions simultaneously as a sale and purchase, a redistribution of assets, and a rejinking of ownership participation, it has the potential to be used in a wide range of circumstances to achieve a number of very different purposes. However, a consequence of its versatility is that share repurchase transactions may be exploited by certain (management/shareholder) groups in a company to that group's advantage and to the disadvantage of another group or groups of shareholders, as well as creditors.

In a sale and purchase context an obvious problem is the availability of price sensitive inside information which is only available to management or controlling shareholder insiders. Exploitation, without disclosure to offerees, of such information is likely to result in the movement of assets (shares) to those insiders at a price which is less than their true current value. Wealth can thus be redistributed from "outsider" shareholders who sell at undervalue to insiders. The exchange of values is unequal because the insiders have exploited their special knowledge to acquire shares at less than the value the market would place on them than if the price sensitive information they have was public knowledge and the market could value the shares on this basis.

So, a sale and purchase will often (in a non pro-rata take-up situation) result in a change in ownership participation and control financed out of company assets which, without full and frank disclosure to offeree shareholders, can result in the passage of control to insiders for a price much less than selling shareholders would rationally be prepared to accept in a fully informed market.

(ii) **Purposes**

Because of the versatility of the transaction, share repurchases have been used to achieve all of the following results in North America:[3]

- fulfil buy-out agreements in closely-held companies upon the death or retirement of shareholders;
- eliminate fractional shares (i.e. less than marketable parcels);
- prevent shares (or further shares) from being transferred to unwelcome outsiders (e.g. special, non-pro rata offers to disaffected members only, or "greenmail" as a defence to a takeover);
- eliminate troublesome shareholders (again, by way of targeted, non-pro rata offer);
- enhance the position of insiders holding large blocks of shares (insiders can consolidate or increase control by making pro-rata offers to all shareholders without intending to take up the offer themselves, thus increasing their proportionate stake in the company);
- delist and/or privatise the company (so-called "going private" transactions);
- reduce the market for, and thus reduce the liquidity of, publicly held shares so as to pressure minority shareholders into selling their shares (minority "freeze out", particularly in the "going private" context);
- comply with statutory appraisal rights afforded dissident shareholders in the cases of mergers and other reorganisations (compulsory minority buy-outs);
- eliminate preferred shares that carry an "unfavourable" dividend rate (and therefore reduce overall cost of capital to the company by lowering the funding costs of equity);
- increase the company's debt to debt plus equity ratio; (i.e. borrow to buy the shares back = more debt but less equity).
- comply with court orders for the protection of oppressed minority shareholders (compulsory minority buy out);
- create a market in the shares of an unquoted company so as to encourage investment by outsiders (increase investment liquidity);

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3 Dugan and Keef, Company Purchase of Own Shares: The Case for New Zealand, Victoria University Press for the Institute of Policy Studies, Wellington, 1987, 14

- reacquire shares from departing employees and thus facilitate the administration of an employee share scheme;
- enable a company to increase its cash reserves by profitable speculation on inside information and/or the cyclical movement in share prices; (i.e. short-term trading in own shares - buy low and sell high on a systematic basis);
- permit the operation of open-ended investment companies (c.f.unit trusts);
- support the market price for the shares (by creating an artificial demand by on-market purchases a signal is given to the market that the shares are presently under-valued);
- increase the net asset backing or earnings per share of remaining shares (by reducing the shares on issue the remaining shares would be entitled to a proportionately greater share of the company's assets available for distribution, after settlement of all prior claims, in a winding-up and would be entitled to a higher dividend per share while the company was still trading, on the assumption that the amount available to be distributed as a dividend was similar to that available before the repurchase, when the dividend had to be distributed amongst a greater number of shareholders);
- satisfy options or make acquisitions (i.e. satisfy options in relation to employee (executive) share schemes by issuing repurchased shares held as treasury stock thus obviating the need to issue new shares and thus dilute earnings per share, or by using treasury stock as consideration for an acquisition, rather than making a cash payment (in the U.S. there was a tax advantage to offeree shareholders in structuring a takeover in this way) without heavily diluting earnings per share);
- absorb excess corporate cash and drive up the market price of shares so as to make a takeover less attractive (by using up cash reserves a "golden egg" is removed from the sights of takeover predators, and the "buy signal" given by a large on-market purchase signals to the market that the shares are undervalued and are thus a rational buy - so the price of the shares goes up, making it a more expensive takeover target);

- and lastly, but perhaps not obviously, as an investment (the purchase of shares in a well-performing company whose business and prospects the Board knows best - its own!).

4. AN OVERVIEW OF THE REPURCHASE APPROACHES IN NEW ZEALAND, AUSTRALIA AND THE U.S.A.

Matrix charts summarising the legislative conditions applied to buy-backs in New Zealand and Australia are contained in Appendices 1 and 2, as is a brief descriptive analysis of the provisions themselves.

In both New Zealand and (to a much greater degree) in Australia a prescriptive approach has been taken whereby numerous conditions and procedures are stipulated in respect of buy-backs generally and also in respect of the separate categories of buy-backs identified in the legislation.

Both the New Zealand and Australian legislation, the Companies Act 1993 (N.Z.) sections 58-67 and 107, and Division 4B of Part 2.4 of the Corporations Act 1989 respectively, provide, inter alia, for the following specific types of buy-back:

(1) Pro-rata (or pari passu) proportional offers

(2) Selective/special offers (targeted offers)

(3) On-market offers

and prescribe separate procedures for each, which are designed to prevent potential abuses of the repurchase mechanism which have been identified as occurring in overseas jurisdictions, most notably the U.S.A., where repurchase has been available for decades.

The prescriptive approach can be contrasted with the permissive approach adopted in American state jurisdictions, where the basic corporations law does not provide a separate regime for repurchases, but rather treats them as a distribution (such as a dividend) and subjects them to a solvency test - usually only a single limb liquidity based test which states that the

distribution can be made (shares repurchased) if the purchasing company will remain able to pay its debts as they fall due in the ordinary course of business after the distribution (repurchase) has been effected.

In New Zealand there is also a solvency test applied to all repurchases. The New Zealand test is two-limbed, with both a liquidity limb (as in the U.S.A.) and also a so-called balance sheet limb, whereby the value of the company's assets must be greater than the value of its liabilities, including contingent liabilities, after the distribution/repurchase. Australia also applies a (single liquidity limb) solvency test to all repurchases.

To prevent abuses of the repurchase power, American jurisdictions also rely on directors' fiduciary duties of loyalty, good faith and acting for a proper purpose to further the best interests of the company.

Additionally, and superimposed on this empowering framework in the U.S.A., the Securities Exchange Commission ("SEC") has formulated a number of specific rules relating to certain types of buy-backs which are perceived to be particularly susceptible to abuse (e.g. "going private" transactions), and to certain practices such as share price rigging, which apply to companies required to be registered under the Securities Exchange Act 1934, i.e. companies with total assets of over $1million and a class of shares held by 750 or more persons. In respect of on-market purchases the State stock exchanges also impose their own listing requirements to ensure that the market is kept fully and fairly informed of all information relating to listed securities of its members which could affect a decision to buy or sell those securities and the price at which they may be acquired or sold.

Clearly the prescriptive approach adopted in New Zealand and Australia (and the U.K.) is very different to the permissive empowering approach adopted in the U.S.A., where a solvency test and directors' fiduciary duties are primarily relied upon to regulate repurchase transactions.

As will be seen in the following transactional analysis, a prescriptive approach creates all sorts of problems and hurdles for legitimate repurchase transactions while failing to provide proper protective mechanisms to prevent abusive repurchase transactions. A clear example is going-private transactions, which can be effected through the more

loosely regulated pro-rata offer procedure or through the special offer procedure, where directors must certify that the transaction is in the best interests of the company and the remaining shareholders. Remaining shareholders are the very group that, through their ability to exploit inside information to their exclusive advantage, will invariably be better off after the transaction where the company's (not the insiders') assets have been used to acquire control, usually by purchasing its own shares at a substantial undervalue.

5. SPECIFIC TRANSACTIONAL ANALYSIS

INTRODUCTION

This part of the paper will take three transactions which are commonly associated with purchase of own shares in the North American jurisdictions, and will subject those transactions to analysis under the New Zealand and Australian provisions to establish if they can be effected in each jurisdiction.

If the transaction is possible in both jurisdictions, I will consider which jurisdiction's provisions enable the transaction in question to be performed in the most efficient and cost effective manner, while also offering protection against any abuses.

The three particular transactions that will be covered in this part of the paper are:

(1) a buy back agreement between shareholders and their closely held company

(2) a going private transaction by a listed company (including the use of purchase of own shares as a takeover defence in the going private context)

(3) a systematic on-market repurchase programme by a listed company to arbitrage capital costs (i.e. monitoring and adjusting the debt to debt plus equity financing ratios (gearing adjustments)), or to stabilise the share price.

1. SHAREHOLDER BUY OUT AGREEMENT IN A CLOSELY HELD COMPANY

(a) New Zealand

In the North American jurisdictions, where share repurchase has been permitted for several decades, a major use to which the technique is put is to enable shareholders in closely held companies to effect an agreement whereby upon a certain trigger event, such as retirement or death, the company's assets will be used to purchase the shares of the exiting shareholder.

Such agreements form a convenient mechanism for the return of capital and a share of the profits to retiring shareholders in a situation where there is no liquid market for the shares. The use of company funds to effect the buy-out agreement means that the remaining shareholders do not have to provide, or borrow, the cash to purchase the retiring shareholder's stake.

Another consequence of buy-out agreements is that a shareholder who wishes to exit the company is not tempted (in the absence of the almost universal "pre-emptive rights" clause in the company's Articles of Association) to sell his or her shareholding to an outside third party. In the absence of the agreed exit strategy which a buy-back agreement represents, and also a pre-emptive rights clause, a departing shareholder could use the threat of sale to an unfriendly/unknown third party as leverage against the remaining shareholders to pay a premium for the acquisition of the shareholding that it would not command if valued without the presence of the coercive premium element.

In short then, buy-out agreements are a convenient method of providing a certain market for the shares of a departing shareholder in a closely held company, where the remaining shareholders wish to keep the shareholding closely held and the departing shareholder requires the certainty of being able to extract the capital he or she has injected and any increase in value of the firm over the relevant period without having to, effectively, put the share parcel up for tender to the highest bidder, if any bidder is available,

serendipitously, at the time that the exiting shareholder wishes to leave the company.

The growth of so-called direct investment companies in New Zealand - companies set up solely to invest in private companies - may ease this liquidity problem in the future. More than $250 billion is invested overseas in private equities. In the United States major funds have more than 6% of their total assets in direct investment, but in New Zealand the figure is less than 1%.[4]

The shareholder entering into such an agreement requires that the agreement is certain and enforceable right from the time that it is concluded, and will want to be certain that the terms of the bargain struck cannot be changed at the whim of a majority of the other shareholders.

Under the Companies Act 1993 the most intuitively appealing way to implement such a buy-out agreement would be by way of a unanimous agreement under section 107(1)(c), since any agreement reached under section 107 in relation to a repurchase would not be subject to the numerous requirements contained in sections 58 to 65, which are considered below.

A section 107(1)(c) unanimous agreement may (pursuant to section 107 (5)) be either:

(a) a separate agreement to, or concurrence in, the particular exercise of the power referred to; or

(b) an agreement to, or concurrence in, the exercise of the power generally, or from time to time.

To be valid and enforceable the agreement must be in writing (section 107(4)).

It could be argued that a written agreement under section 107(5)(a) appears to contemplate a repurchase transaction contemporaneous with, or close in time to, the agreement or concurrence, but it is submitted that the better

4 The Independent, 7 October 1994, 35

view is that section 107(5)(a) is not so limited, and could be used to effect a long-range buy-out agreement. An agreement under section 107(5)(b) clearly contemplates the periodic exercise of the power at times in the future.

If a section 107(5)(a) agreement does contemplate a particular exercise of the buy-out power which is not limited to a buy-out contemporaneously with, or close in time to, the agreement or concurrence then this would provide a suitable vehicle for a buy-out agreement because the only resolution and certification required would be as to solvency, and there is no ability to withdraw agreement, as is the case under a section 107(5)(b) type agreement.

If only the section 107(5)(b) procedure is available then there is a major problem.

Section 107(6) effectively enables shareholders entering into a section 107(5)(b) unanimous agreement to have a "bob each way", by permitting them to withdraw from the agreement at any time. This immediate right of withdrawal from the agreement makes the procedure under section 107(5)(b) inappropriate to effect a buy-out agreement because there is no certainty for the shareholder whose shares are to be acquired that the agreement will not be rendered ineffective at some time in the future by the withdrawal of one or more of the other parties to that agreement.

It is not obvious why section 107(6) appears in the Act. The whole scheme of section 107 is to provide a method of consensual contracting out of certain requirements of the Act. To permit a unilateral withdrawal from such an agreement freely entered into appears to provide an unjustifiable departure from the normal rules of contract that an agreement freely entered into, and in the absence of fraud, is enforceable against the party undertaking the obligation unless the other party to the contract agrees otherwise, and notwithstanding that circumstances may have changed since the agreement was entered into.

A typical buy-out agreement will provide a pre-emptive provision whereby if an exiting shareholder desires to sell his or her shares he will first offer them to the company, and also a provision that upon the death, notified

retirement or other specified conditions then the company unequivocably agrees to purchase the shares of the departing shareholder at a price to be determined in a specified manner.

Alternatives for determining the price to be paid for the exiting shareholder's shares could be to determine the net asset backing of the shares at the time that the buy-out agreement is first concluded, and then provide for an annual reassessment at the time that the company's annual report is prepared. Thus the price determined at the time that the latest annual report is prepared, immediately before the exiting shareholder is to depart, will provide the price to be paid for the shares. Another, possibly less cumbersome method, would be to provide an independent valuation of the shares to be performed.

In relation to the timing and method of payment, it is unlikely that a company will be able to completely cash out a departing shareholder in one hit. It is far more likely that a form of instalment payment arrangement will be entered into. The frequency, timing and duration of such instalment payments will depend on the cash flow profile of a company, retained earnings available for distribution, and generally the working capital requirements necessary to keep the business operating as a profitable going concern.

If an instalment arrangement is entered into, then clearly the solvency test must be satisfied before each and every instalment payment is made. While, on its face, this is a reasonable requirement, this does raise the prospect that a majority of the remaining shareholders could manipulate the financial affairs of the company, by stripping assets, or creating liabilities, such that instalment payments (distributions) under the buy-out agreement will not be able to be made, as they would appear to cause the insolvency of the company. So, in a sense, any departing shareholder faces the prospect of having the sword of Damocles over his or her head every time an instalment comes up for payment.

If the shares remain vested in the exiting shareholder until all of the instalments are paid in full, as may sometimes be the case, this would mean that the voting rights attaching to the shares would also remain with the exiting shareholder, or if he or she is deceased, with his or her personal

representatives who will often have no knowledge of the business or particular business skills. In the latter circumstances decision-making ability in the company could be very badly affected, in some cases affecting the viability of the business itself. If the exiting shareholder is still alive, the ability to exercise voting rights could provide a potential lever over the remaining shareholders to extract un-bargained for concessions or advantages in return for compliance in voting or other company administration or decision-making pattern. An obvious example would be a refusal to go along with the majority in matters requiring unanimous consent to take advantage of the section 107 contracting out provisions in relation to, for example, payment of dividends (section 107(1)(a)) or loans or other payments to directors under section 161 (section 107(1)(f)).

Also, if the exiting shareholder continues to hold at least 25% of the voting power he or she could block all special resolutions, including those necessary to sanction the entering into of "major transactions" under the Act.

Given the undesirability of the above, it would seem preferable for the shares (and the voting rights) to be cancelled or held as non-voting treasury shares immediately to enable the remaining shareholders to carry on the business as they see fit, and to convert the exiting shareholder's stake from an equity holding to a debt investment, secured over the assets of the company to the extent possible, and subject to any existing statutory subordination of priorities in favour of other company creditors.

Turning now to the share repurchase provisions themselves, it appears that the only two options which may be available to effect a buy-out agreement would be sections 60 and 61. Under section 60(1)(a) a pro-rata offer could, theoretically, be made to all the shareholders in the closely held company, with the intention being that only the proposed departing shareholder take up the offer. Section 60(2)(a) permits the company to acquire additional shares from a shareholder to the extent that another shareholder does not accept the offer, or accepts the offer only in part. In this case only the departing shareholder would be selling, so the shares not taken up from the remaining shareholders could be purchased from the exiting shareholder.

Unfortunately, the Board may only make such a pro-rata offer if it has previously resolved pursuant to section 60(3) that:

(i) the acquisition is in the best interests of the company; and

(ii) the terms of the offer and the consideration offered for the shares are fair and reasonable to the company; and

(iii) it is not aware of inside information.

Pursuant to section 52 the Board must also resolve and certify that in their opinion the company will, immediately after the distribution, satisfy the solvency test.

The resolutions required by section 60(3) clearly contemplate a purchase of shares in the near future. This is completely inappropriate in the context of a buy-out agreement where the buy-out will not occur until some time far in the future. In these circumstances it is impossible to certify prospectively that the acquisition will be in the best interests of the company, that the terms of the offer and consideration offered will be fair and reasonable to the company, that the Board will not be aware of any inside information and that the company will still be solvent after the repurchase! The financial situation of the company, and the economy in general, may change so much in the period between the conclusion of the buy-out agreement and the time when the agreement is to be effected and the purchase made that the resolutions may no longer be true and accurate. All the directors could do in these circumstances was certify the matters as at the time that the agreement was entered into.

The section 60(1)(a) pro-rata offer procedure could, of course, be used at the time that the departing shareholder intended to leave the company, but this is unsatisfactory from the point of view of the departing shareholder because it does not provide the necessary ex-ante certainty required by a shareholder in this position, who requires a guaranteed exit strategy from the company. Market circumstances, and business relationships, may also have changed so much in the interim that the departing shareholder may

not be able to rely on the full support of the Board to enter into such a transaction at the time when he or she needs to exit.

The other possibilities are a special offer in terms of either section 60(1)(b)(i) or (ii). Section 60(1)(b)(i) provides that an offer can be made to one or more shareholders to acquire shares if the offer is one to which all shareholders have consented in writing. On its face, this appears to be similar to the section 107(5)(a) unanimous agreement provision. However, the resolutions required by section 60(3) (discussed above) also apply to an offer under section 60(1)(b)(i), so that this method also would not be available to effect a buy-out agreement.

Under section 60(1)(b)(ii) an offer to one or more shareholders can be made if it is expressly permitted by the constitution and is made in accordance with the special offer procedure set out in section 61. Section 61(1) requires that the Board may only make an offer under section 60(1)(b)(ii) if it has previously resolved:

(i) that the acquisition is of benefit to the remaining shareholders; and

(ii) that the terms of the offer and the consideration offered for the shares are fair and reasonable to the remaining shareholders.

These resolutions are in addition to the resolutions required by section 60(3).

Again, clearly, these are inappropriate requirements which cannot be complied with in the context of a prospective buy-out agreement. These matters can only be certified to in any accurate and meaningful way very close to the time that the buy-out is to be effected. These matters cannot be certified to many years in advance and still comply with the requirements of the Act.

A further "deal breaker" is that under section 61(6) the offer to purchase must be made not less than 10 working days <u>and not more than 12 months</u> after the disclosure document (required by section 61(5)) has been sent to

each shareholder. Twelve months is an impractical event horizon in the context of a proposed long-term buy-out agreement.

In essence then, a buy-out agreement in a closely held company could only be implemented under one of the four off-market modes discussed above, namely a section 107(5)(a) unanimous agreement. In the case of a section 107(5)(b) unanimous agreement, the agreement can be broken at any time, and, in the case of the pro-rata and special offer procedures, those procedures contemplate that the acquisition of the shares will be effected in close proximity to the time of the actual offer. The required resolutions cannot sensibly be made and certified at the time of the entering into of the agreement, but only when the buy-out is to be performed some time in the future.

Given this, there is no certainty for the prospective departing shareholder because the enforceability of the buy-out agreement would depend on the Board's views of the company's best interests at the time of the member's retirement. Since the best interest test applies at the time of performance the remaining shareholders could easily prevent the company from performing its obligations under the buy-out agreement by refusing to certify.

The position of a shareholder seeking to enter into a buy-out agreement is improved if the only requirement to be met is the general solvency requirement set out in section 52 of the Act relating to distributions; the position under a section 107(5)(a) agreement. But even with the solvency test remaining as the sole hurdle, intransigent or disaffected remaining shareholders could, through a variety of techniques, artificially manipulate the financial position of the company, in the years or months leading up to the date when the buy out agreement was to be performed, so that the company's financial position was such that they could not certify that the solvency test could be met at the time fixed for the buy-out.

A further issue that impacts upon buy-out agreements under the Act is the statutory subordination in sections 67(3) of the Act, of an unpaid seller under a repurchase transaction to the claims of other creditors, but in priority to the other shareholders. Given the multitudinous protections in the Act which are designed to prevent abuses of the share repurchase

power, and in particular the necessity to "pass" the solvency test, it is difficult to justify this statutory subordination.

It is submitted that it would be preferable for claims of unpaid sellers to be treated as an equal priority to claims of any other creditor of the company. This is particularly the case given that rather than contributing equity capital, a shareholder could contribute a nominal sum by way of subscribed capital, with the bulk of their financial contribution to the running costs of the company being provided by way of a loan secured in the normal way, by floating charge or mortgage.

If most of the funds were contributed by shareholders way of loan secured by a charge then the shareholders, in their guise as creditors of the company, would be entitled to a priority over other unsecured creditors, but most usually second in priority to a bank or other financial institution which provides the bulk of the funding under a floating charge or first mortgage security. If, however, a different capital structure was chosen whereby the funds were injected as paid up capital then the unpaid shareholder on a repurchase would rank after unsecured creditors. This result seems quixotic and unjustifiable.

In this regard it must be noted that in the Australian context, section 133 R D (ranking of seller's claim in winding up) is subordinated (in a similar fashion to section 67(3) of the Companies Act 1993 (N.Z.)) to the rights of all other creditors, but retains a priority over claims of shareholders in a winding up; again, an unsatisfactory situation for an exiting shareholder.

In conclusion, it seems clear that despite share repurchase being utilised extensively overseas to provide for buy-out agreements in closely held companies, only one of the New Zealand provisions are suitable to effect this type of transaction, namely a section 107(5)(a) unanimous shareholder agreement.

The focus of the core New Zealand provisions is on a repurchase which occurs shortly after resolutions have been made authorising the repurchase and certifying as to the various matters described above. In a buy-out agreement the performance of the contract will usually not take place for

some years until after the buy-out agreement has been entered into, making any attempted initial certification meaningless.

In addition to the section 107(5)(a) procedure the only other way to provide for a type of buy-out agreement appears to be by using the redeemable preference share provisions in the Act, a technique that was used to effect this type of transaction before the 1993 Act came into force. It seems rather ironic that due to the shortcomings of the new share repurchase provisions, shareholders wishing to obtain the ex-ante certainty of a guaranteed exit strategy from a company some years down the track, and who, for whatever reason, do not consider the section 107(5)(a) procedure appropriate, or who cannot achieve the required unanimity to conclude a section 107(5)(a) agreement, must use the same techniques they did before the reforming legislation was passed.

Redeemable Shares

In many respects the provisions on redemption of shares in the Companies Act 1993 in relation to shares which are redeemable at the option of the company parallel the provisions on share repurchase, seeking as they do to prevent the same perceived abuses of the procedure, and, accordingly, the same type of problems identified above apply.

Section 68 of the Act makes a distinction between shares which are redeemable:

(a) at the option of the company; or

(b) at the option of the holder of the share; or

(c) on a date specified in the constitution ....

In respect of shares redeemable at the option of the holder of the share, or shares redeemable on a date specified in the constitution, sections 74 and 75 of the Act are in practically identical terms in providing that when the share becomes redeemable, either because the holder of the share has given proper notice to the company to redeem the shares on a particular date, or the specified date for redemption comes around, then:

(a) the company must redeem the share on that date; and

(b) the share is deemed to be cancelled on that date; and

(c) from that date the former shareholder ranks as an unsecured creditor of the company for the sum payable on redemption.

Furthermore, a redemption effected under section 74 or 75 is not classified as a distribution for the purposes of the solvency test, because redeemable preference shares are more akin to debt instruments than equity shares and, accordingly, any redemption is in the nature of the repayment of a loan, not a distribution of company capital. Also, the terms of redemption are set when the shares are issued and so creditors looking to the company should, theoretically, have the ability to inform themselves of the contingent liability which the redeemable preference share represent, before agreeing to lend to the company.

Rather, a redemption is deemed to be a distribution for the purposes of section 56, which relates to recovery of distributions made to a shareholder at a time when the company did not, immediately after the distribution, satisfy the solvency test. In effect then, while the redemption does not have to pass the solvency test before a pay out is made, if it subsequently transpires that the company was insolvent after the distribution then that distribution can be recovered. Effectively, the application of the section 56 recovery procedure treats redemptions while insolvent as voidable preferences, and thus recoverable for the benefit of all creditors.

By using the redeemable preference share mechanism under section 74 or 75 the particular certification requirements that are present in the context of purchase of own shares can be avoided. For the reasons noted above, the solvency test does not have to be passed and certified to and there is also no necessity to certify in respect of the proposed redemption being in the best interests of the company, that the consideration is fair and reasonable either to the company or the remaining shareholders, and also that the Board is not aware of any inside information. The resolutions required in relation to issue of redeemable shares are concluded at the time

the shares are issued. It is inappropriate that they be repeated before any proposed redemption can be effected.

As an exit strategy, the redeemable share provisions could be used to structure the buy-out agreement so that the shares were redeemable either at the option of the exiting shareholder (i.e. upon retirement or any other particular event), or they could be triggered by a particular event such as the death or disablement of that shareholder. Given the parallels between section 74 and 75 it would appear that a shareholder wishing to use either of these avenues would not be disadvantaged by choosing either option. A formality applicable to both section 74 and 75 is that the company's constitution must provide for the redemption of the share by that company. This could be provided for either in the original constitution of the company or by amendment at a later date, following the amendment procedures contained in the constitution. Such an arrangement should operate in a very similar manner to buy-out agreements under North American practice which use a purchase of own shares as the vehicle for the buy-out agreement.

On its face then this procedure would seem to be ideal. However, problems with the procedure are the fact that since the redemption of the shares and the mechanisms relating thereto are contained in the constitution of the company, these provisions will most likely be able to be altered, subject to the terms of the constitution, by a three-quarter majority special resolution, and in the absence of some other super-majority or unanimity requirement which is applied specifically to the terms of issue and redemption of the preference shares. In some circumstances, e.g. where there are only two or three shareholders, then clearly the exiting shareholder will always (and in the absence of the super-majority or unanimity requirement in the constitution, referred to above) be in a position to block the passage of such an amending resolution. However in a situation where shares are held in unequal portions, or where shares are held in equal portions but there are more than three shareholders, then the required ex-ante certainty from the point of view of the exiting shareholder may not be present.

The claim of a shareholder whose shares have not yet been (fully) redeemed under section 74 or 75 is treated as un unsecured creditor

(sections 74(1)(c), 75(1)(c). In this regard a buy-out agreement concluded under the redeemable share provisions provides greater protection to an exiting shareholder than under a section 107(5)(a) unanimous agreement in the event of a winding-up because the unpaid sums are accorded priority over shareholders' claims, as unsecured debts. Under a section 107(5)(a) agreement unpaid sums rank after unsecured debts on a winding up.

As noted above, shares redeemable at the option of the company are subject to rules which are substantially like those applicable to a purchase of own shares (because the company can decide when to redeem them) and therefore make them an inappropriate method of effecting a buy-out arrangement.

(b) Australia

Close Corporations Act 1989

The starting point for any discussion of buy-out agreements in closely held companies in an Australian context is the Close Corporations Act 1989.

As of October 1994, the Act had still not been proclaimed to come into force.

The Act is designed to cater for up to 10 shareholders to operate in a less formal, quasi partnership, structure than a larger company formed under the Corporations Act. In exchange for a less formal and less flexible business structure, close corporations are not permitted to offer their shares for subscription to the public.

Part 10 of the Act provides for matters relating to shares. Division One deals with the acquisition by the close corporation of its own shares. Section 87 provides that a close corporation is not to acquire any shares or units in itself except in accordance with the provisions of the Act. A close corporation may acquire its own shares if the requirements of sections 89-92 have been complied with. However, any acquisition by a close corporation of its own shares is not invalidated by an acquisition in contravention of the Act's provisions.

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Section 89 provides that a "decisive number" of members must have, within six months before the acquisition:

(a) consented in writing to the acquisition; and

(b) signed a declaration in writing that they have made an inquiry into the affairs of the Corporation and have formed the opinion that the Corporation will after making any payment to the acquisition of the shares, be able to pay its debts as and when they become due. A member must have reasonable grounds for the opinion expressed in the declaration.

It can be seen that unlike the solvency test in the New Zealand Companies Act 1993, the Close Corporations Act declaration has a single limb relating to liquidity, not a dual limb relating to both liquidity and balance sheet solvency.

By virtue of section 90, after a declaration of solvency has been made any member who signed the declaration and subsequently has reason to believe that the Corporation is or may be unable to pay its debts when they become due may withdraw from participation in the declaration of solvency.

Section 91 provides for the publication of a notice of proposed acquisition of the shares by the close corporation. After the declaration of solvency has been signed, the corporation must publish a notice in all of the areas where it carries on business:

(a) stating that the corporation proposes to acquire the shares three weeks after the date specified in the notice, being a date that is not earlier than seven days after the publication of the notice;

(b) specifying the amount to be paid for the shares;

(c) stating that a declaration of solvency has been made and is available for inspection at the registered office of the corporation; and

(d) setting out the fact that any creditor who, at the date provided in the notice, is entitled to any debt or claim which, if the date for the commencement of the winding up of the corporation, would be admitted in proof against the corporation may apply to the court for an injunction restraining the corporation from acquiring the shares.

This public notice procedure, with the attendant risk of creditor injunctive claims to frustrate a buy-out payment, clearly detracts from the Act's utility to effect a certain buy-out agreement.

Section 92 provides that any shares acquired by a close corporation in itself must be cancelled. The close corporation is not entitled to re-issue any shares so acquired, and any re-issue of shares is void.

An immediate problem which arises from the perspective of a shareholder in a close corporation seeking to enter into a certain and binding agreement with the corporation to acquire his or her shares at some time in the future, is the provision of section 89 which requires that a decisive number of members must have within 6 months before the acquisition, consented in writing to the acquisition and signed the solvency declaration. With the six months event horizon, it doesn't appear that an agreement can be entered into under the section which would provide the necessary ex-ante certainty for an acquisition at some time in the quite distant future.

Part 7 of the Act deals with the internal administration of close corporations. Section 67 provides that all of the members of a close corporation may enter into a written agreement between themselves relating to the management of the affairs of the corporation. The agreement is called an association agreement, and the association agreement may be varied at any time by a written suplementary association agreement or by written supplementary association agreements. A written supplementary association agreement may be made if such agreement is entered into by a decisive number of members. An association agreement is binding on every person who is from time to time a member, including a person who became a member after the agreement was entered into, and a supplementary association agreement is binding on every person who is

from time to time a member, even if the person was a member when the agreement was entered into, but did not enter into the agreement, and also includes a person who became a member after the agreement was entered into.

The association agreement is designed to operate as the Articles of a normal company. As such the association agreement mechanism would be inappropriate for concluding a binding long-term buy-out agreement in a closely held company. It can be seen from the above that, just like Articles of Association, the agreement can be altered by a "decisive number" of members. Decisive numbers of members are defined in Division 2 of the Act as:

(a) where there is only one member - that member;

(b) where there are two members - both of those members; or

(c) where there are more than two members - not fewer than:

(i) if there are three members - two members;

(ii) if there are four members - three members;

(iii) if there are five members - four members;

(iv) if there are six members - five members;

(v) if there are seven or eight members - six members;

(vi) if there are nine members - seven members; or

(vii) if there are ten members - eight members.

So, it is true that when there are more than two members then more than a bare majority is required to change an association agreement, but this will still not provide the necessary ex-ante certainty to conclude a long range buy-out agreement, unless a higher threshold vote than a "decisive number" can be negotiated by the existing shareholder, e.g. a unanimity

requirement for any changes to the association agreement, but the Act does not appear to permit this, premised, as it appears to be, on the will of the (super) majority prevailing. A strong argument can thus be made that the policy of the Act is not to permit a minority to frustrate the workings of the close corporation - something a unanimity requirement would certainly do.

This is particularly the case when the provisions relating to association agreements are read together with the separate requirement in section 89(1) of the Act, referred to above, that within six months before the acquisition a decisive number of members must also have consented in writing to the acquisition. For these reasons it is submitted that the Close Corporations Act probably does not provide a suitable mechanism to conclude a long-range buy-out agreement.

Consequently even if the Close Corporation's Act 1999 is finally proclaimed to come into force, it will still be necessary to consider the buy-back provisions in Division 4B of Chapter 2 of the Corporations law.

<u>Division 4B of Part 2.4</u>

The Division 4B of Part 2.4 share repurchase provisions make a distinction between self purchases by public and proprietary companies. In the context of a consideration of a buy-out agreement in a closely held company, it is only appropriate to consider the repurchase provisions as they relate to smaller proprietary companies. The three possible options appear to be a purchase under a buy-back scheme (pro-rata offer) under subdivision F, a purchase of employee shares under subdivision H, or a selective (special/targeted) buy-back under subdivision J.

In relation to a buy-back scheme, as well as in relation to a selective buy-back, and an employee share purchase, section 133DA requires that the buy-back be authorised in the Articles of the company. As discussed above, any provision contained in the Articles is susceptible to removal or amendment by either a majority or a super majority, depending on the conditions applying to those Articles. This mutability of the Articles makes them an inappropriate vehicle to provide a prospective departing shareholder's necessary ex-ante certainty, unless the Articles provide the necessity for unanimity to alter the relevant Article, or near enough to

unanimity to enable the exiting shareholder to block any proposed changes, and that provision is itself subject to a unanimity requirement - a form of "double entrenchment".

A declaration of solvency is also required in relation to buy-back schemes (section 133MA) selective buy-backs (section 133MB), and employee share purchases (section 133MB). The comprehensive requirements of such a solvency declaration are contained in section 133BH. The term "solvent" is defined in section 95A to mean that a company is solvent if, and only if, it can pay its debts as and when they fall due and payable. Any solvency declaration made by each director remains in force for a period of 12 months, starting on the day on which it is made, unless it is earlier revoked under section 133MD. Subdivision M sets out in detail the solvency requirements applying to all types of buy-backs.

Once again, a solvency requirement necessarily detracts from the certainty of a long-range buy-out agreement. However, it is submitted that in all cases a declaration of solvency should be a pre-requisite in respect of any type of buy-out, including one intended to be effected under a buy-out agreement in a closely held company.

In relation to a proprietary company, if the proposed buy-back is to exceed the so-called 10% in 12 months limit then an audited solvency declaration is required (section 133MA). This is a solvency declaration provided by the Board which is audited and a certificate provided by an independent auditor. If the 10/12 limit is exceeded in respect of a selective buy-back or an employee share purchase buy-back by a proprietary company then an audited solvency declaration is also required in these instances (section 133MB). Clearly in the case of small proprietary companies the requirement for an independently audited solvency declaration will often be impractical, arguably adding significant and unnecessary complexity and transaction costs.

In the case of a buy-back scheme an ordinary resolution of shareholders is required to be passed if the 10/12 limit is exceeded, or a takeover is pending or remains open at the time of the offer (section 133GA). In the case of an employee share purchase, an ordinary resolution is also required in these circumstances (section 133HA). If the buy-back is a selective

buy-back (as it will be under a buy-out agreement) then there is also a special 75/75 majority resolution requirement if the 10/12 limit is exceeded (section 133JB).

It follows that unless the buy-out agreement is structured as an instalment repayment over a number of years then in many instances the 10% in 12 months limit will be exceeded such that either an ordinary resolution (buy-back scheme or employee share purchase), or a special resolution (selective buy-back) will be required to authorise the repurchase. In a two person company the 10% in 12 months limit would require a pay back period of five years to fully pay for the shares proposed to be repurchased from an exiting shareholder. Clearly this is impracticable and the final pay back period in most buy out agreements would ideally be significantly shorter than this.

The same problems discussed above in relation to the necessity for the solvency test to be passed in New Zealand before each instalment payment is made to an exiting shareholder apply equally in the Australian context, with the potential existing for a majority of the remaining shareholders to manipulate the company's financials, or strip its assets, so that a payment cannot be made without, apparently, rendering the company insolvent. In particular, section 133 RB(2) provides that a buy-back agreement cannot be enforced unless the company will remain solvent for at least 12 months after the payment is made for the shares under the buy-back agreement. Where repayment instalments are to be made monthly then clearly the potential effect of these successive instalment payments must also be considered <u>each time</u> an instalment falls due for payment.

An added frisson of terror for certifying directors is that if the company does become insolvent within 12 months of any successive declaration of solvency, (apparently whether or not the insolvency can be traced back directly to that particular payment, or is the result of other unrelated payments or matters) then each certifying director is personally liable to indemnify the company for the full amounts of distributions paid out during the 12 month period prior to the insolvency (section 133QC), subject to the defence that at the time the solvency declaration was signed the director had reasonable grounds for his or her belief, and did not

subsequently have any reason to no longer consider those reasonable grounds for belief still existed (section 133QC(6)).

From the prospective departing shareholder's perspective, a problem with the ordinary (pro-rata or employee buy-back) or special (selective buy-back) resolution procedure required where the 10% in 12 months limit is to be exceeded is that any buy-out agreement could be frustrated by a majority, or where applicable, a super majority of shareholders refusing to vote in favour of the resolution. This is no problem if the departing shareholder is a controlling shareholder and can muster the necessary votes to pass the ordinary or special resolution, but in most instances in relation to closely held company a departing shareholder will not be able to muster the required majority. This requirement therefore makes the share repurchase provisions an inappropriate and ineffective mechanism to provide a satisfactory means of concluding a buy-out agreement in a closely held company, unless agreement to a requirement for unanimity for changes to the relevant Article can be extracted by the exiting shareholder from the remaining shareholders at the time, or before, the buy-out agreement is concluded.

A further potential problem is that the buy-back authorisation must be contained in the Articles and must be renewed at least every three years (sections 133DA, 133DB). Subject to the comments above, both of these provisions are also vulnerable to change - the authorisation could be removed or modified at any time, or not renewed when due.

Another complicating factor is that subdivision L provides a procedure whereby creditors may object to proposed buy-backs. The sections contained in this subdivision provide for a procedure to advertise buy-backs by the publication of a notice containing details of the buy-backs, and a solvency declaration. Notice must be circulated either nationally or in the area in which the company operates (section 133 LC). Any creditor may apply to the court for an injunction to stop the proposed buy-back (section 133LD), and the court may prohibit the buy-back if it is satisfied that either the company is insolvent or that a solvency declaration specified in the notice is no longer in force, or it is unlikely that the company will remain solvent if the buy-out is effected (section 133LE). The administrative burden and expense of providing a notice should not

provide an insuperable difficulty in relation to a buy-out agreement in a closely held company and, if the company is solvent then a creditor would not succeed in an application to injunct the buy-out. However, it is one more statutory requirement and expense that must be complied with and borne in the context of a purchase of own shares which detracts from the simplicity, speed and utility of the procedure without, arguably, providing a countervailing protective benefit which outweighs the expense and inconvenience of the procedure.

For the reasons above it is concluded that neither the Close Corporations Act 1989 (if it is ever proclaimed to come into force), nor the provisions of the Corporations Act 1989 are likely to provide a viable or acceptable method to effect a buy-out agreement in a closely held company.

Redeemable Preference Shares

Section 120 provides for the issue of preference shares redeemable at the option of the company, or otherwise. The redemption of such shares is treated in the traditional way with the pre-conditions for redemption being that the redemption funds come from either profits otherwise available for dividends or out of the proceeds of a fresh issue of shares made for the purpose of the redemption. It will be recalled that under the Companies Act 1993 (N.Z.) shares redeemable at the option of the company are subject to the solvency test (and, in effect, treated as a repurchase) and other redeemable shares are only brought within the "solvency net" and treated as distributions for the purpose of recovering amounts paid to redeem shares when the solvency test is not satisfied immediately after the redemption, and, presumably, only if the company is wound up.

The issues raised above in relation to potential majority manipulation of the Articles, to override or amend the terms of redemption or the conditions concerning a fresh issue of shares, and manipulation of the company's financial situation to make any profits available for dividend distribution magically disappear, apply equally in the Australian context.

Given the continuity of legislative treatment in Australia in relation to redeemable preference shares, it is likely that buy-out agreements in closely-held companies will continue to be effected by this mechanism,

since the new share repurchase provisions and the (as yet unproclaimed) Close Corporations Act do not appear to provide a suitable alternative avenue.

2. GOING PRIVATE TRANSACTIONS

(a) New Zealand

The term "going private" refers to a publicly listed company repurchasing a sufficient number of its own shares so that it no longer meets the relevant Stock Exchange's listing requirements (i.e. shareholding "spread" requirements) and, as a consequence of such non-compliance, is delisted from the Stock Exchange. Under the old Companies Act 1955, an analogy would be with a public company delisting and becoming a private company. Of course, under the Companies Act 1993 there is no distinction drawn between public and private companies, only between listed and unlisted companies.

Going private transactions are most commonly associated with takeover defence strategies, or as a strategy by a powerful insider group to further consolidate its control of the company and thus capture for itself future gains to be made by the company. Insiders may exploit special information to which only they are privy, e.g. knowledge that the company's trading prospects are going to improve markedly in the future. Clearly, if offeree shareholders are not aware of these prospects because the price sensitive information is not public, then they will be prepared to accept a price for their shares which does not factor in this inside information and is therefore likely to result in an acquisition of their shares at an undervalue. Wealth would thus flow from outsider offeree shareholders to insider offeror shareholders.

In North America it has been a common tactic in a going private transaction to make a so called two tiered-offer. The first tier of the offer is a pro-rata offer to acquire a proportionate number of each shareholder's shares. This part of the offer is intended to significantly reduce the number of shares outstanding. The second tier of the offer is a selective, or targeted, repurchase. In the targeted repurchase perhaps a single or a limited number of large shareholders would be made an offer at a premium

for their shares, in order to consolidate the control of the offeror insiders. When a sufficient level of control has been achieved, the selective offer to a single or a few major shareholders may be supplemented, depending on the circumstances, with a so-called "bundled offer", whereby a further targeted offer, or pro-rata offer, is made to the remaining shareholders to acquire all of their shares at the same price. In practice the selective offer is more common because once the company is able to delist then any remaining minority may be frozen out by a variety of tactics such as a staged amalgamation, hiving off all assets to a separate company and winding up the original company, or, perhaps, to announce a reduced or no dividend policy for future years. Shareholders dependent upon the income from their shares will be more willing to sell in these circumstances than if a previous dividend rate was maintained. While, theoretically these tactics should be capable of being restrained, or compensation paid to affected shareholders after the event to compensate them for their loss, due to the business judgment rule in North American jurisdictions, and difficulties of proof of loss, often shareholders are left with no effective remedy, and no choice but to sell out.

It is worth noting in passing that though New Zealand has no statutory or recognised common law business judgment rule, the Courts have been extremely reluctant in New Zealand to second-guess management decisions, in all but the clearest cases of abuse. Since the means of proof of wrong doing is almost invariably confined to the inner sanctum of the Board, and perhaps a major shareholder or shareholders acting in collusion, it is almost impossible for aggrieved shareholders to succeed on the basis of breach of directors' duties either to themselves, qua shareholders, or even more particularly in relation to breach of directors' duties to the company so as to found a derivative action in the name of the company.

A management or management/shareholder group which intends to take a public company private, either as a defence to a threatened takeover or to capture future profits for themselves, has a number of options, through the share repurchase mechanism, under the Companies Act 1993.

The obvious first step would be a pro-rata offer under section 60(1)(a). Under section 60(3) the Board may only make such a pro-rata offer if it has previously resolved:

(1) that the acquisition in question is in the best interests of the company; and

(2) that the terms of the offer and the consideration offered for the shares are fair and reasonable to the company; and

(3) that it is not aware of any information that will not be disclosed to shareholders -

(i) which is material to an assessment of the value of the shares; and

(ii) and as a result of which the terms of the offer in consideration offered for the shares are unfair to shareholders accepting the offer.

In addition, subsection 4 requires that the directors' resolution must also set out in full the reasons for the directors' conclusions.

By structuring the going private transaction as a pro-rata share repurchase the insiders clearly have no intention of taking up the pro-rata offer themselves. However, by using the section 60(1)(a) procedure the Board does not have to comply with the disclosure requirements which would apply if the offer was structured as a special offer under section 60(1)(b) and section 61. It is a bizarre result that a going private transaction can be effected under the less stringent regime for pro-rata transactions, even though, as noted above, the offer will not be taken up proportionately because the insiders have no intention of selling their shares. Their interest is quite the opposite, being to consolidate their control of the company and take it out of the public arena, thus capturing future profits for themselves alone, or, in a takeover situation, removing the company from the takeover arena.

The first leg of the trifecta that the Board must resolve is that the acquisition is in the best interests of the company. It would be a simple matter for the Board to rationalise this ground by stating that with a reduced shareholding transaction costs would be reduced to the benefit of

the company. By going private the company would no longer have to pay listing fees, and with a shrunken shareholder base the servicing costs of distributing annual reports and other requisite information to shareholders would also be proportionately reduced. Again, it is submitted that the Courts, except in the face of very strong evidence to the contrary, would not second-guess the Board's apparent commercial assessment. A de facto business judgment rule would, in all likelihood, be applied with the Court refusing to look behind the Board's resolution.

The second requirement is that the terms of the offer and the consideration offered for the shares are fair and reasonable to the company. Again, this should not prove a great hurdle to the Board. In order to fire-proof itself the Board would merely need to make an offer at, or at a slight premium above, the current prevailing market rate, in order to make the offer of reacquisition attractive to offeree shareholders. It is hard to see how an aggrieved shareholder would succeed in a claim for injunctive relief, a derivative action, or a personal action on the basis that the company was disadvantaged by the offer, the consideration for which was at or near the prevailing market price. Obviously, the lower the price at which the shares could be acquired then the more likely is the acquisition to be in the best interests of the company and the price offered is fair and reasonable to the company.

The third matter that must be resolved is that the Board is unaware of any price sensitive inside information. Again, this should not prove unduly burdensome to a determined Board. Even if the Board was of the view that the future profitability of the firm was likely to improve considerably, it could argue that this was entirely speculative and with no knowledge of existing facts which could affect the market price of the shares in question. It would be far more difficult if the Board was aware of large and profitable contracts which were to be concluded, or business opportunities which were effectively "in the bag". However, it is of the very essence of inside information that it is known only to a few parties. It would not be difficult for a unscrupulous Board to delay signature of contracts and restructure commercial documentation in order to give the impression that the deals were less than certain to be concluded at the time of the offer, or that there were real outstanding contingencies.

It can be argued with some force that the second limb of this third requirement should, in theory, prevent a going private transaction proceeding where an insider group intends to capture for itself future benefits which would otherwise be distributed amongst all shareholders. This limb requires that the Board must not be aware of information which makes the terms of the offer and the consideration offered for the shares unfair to shareholders accepting the offer. In a perfect world a Board would not certify to these matters in the circumstances discussed. However, the reality is that such abuses have occurred in the past, and will continue to occur, and a resolution and certification procedure is unlikely to prevent future abuses unless human nature changes dramatically for the better. In short, the certification requirements under the section 60(1)(a) pro-rata procedure will, in reality, offer no protection at all against an unscrupulous insider group determined to capture future benefits for itself.

If the facts are changed so that the going private transaction is treated as a response to a perceived or threatened takeover bid, then the analysis is slightly different. Under the first limb of the subsection 3 requirements the Board must justify the transaction as being in the best interests of the company. Again, it should not be difficult for a determined management to find apparently cogent reasons under subsection 4 to fulfil this limb. The Board could cite its apprehension that the raider did not intend to add value to the continuing business, but rather was an asset stripper whose only intention was to get its hands on undervalued assets and break up the company, rather than continuing to trade as a going concern. Another reason could also be that the Board considers the business philosophy of the raider to be incompatible with the existing culture of the company, so that an acquisition would be dysfunctional and would not benefit the company's ongoing operations. Management could also state that it had a number of business strategies and initiatives in place or contemplated that would significantly add value to the company, and that these initiatives would be put at risk, and may never be implemented, if the takeover took place. It would be resolved by the Board that this would diminish the value of the company, and the share buyback was therefore necessary to preserve these opportunities and the possibility of converting them into increased shareholder wealth.

It would appear that the only way that a Board could be gain-said by a hostile shareholder would be if that shareholder had access to inside information which cast a real doubt on the motives of the certifying Board.

Under the second limb, if the pro-rata offer price was at market price or at a slight premium above it is submitted that it would be practically impossible to show that the terms of the offer and consideration for the shares were not fair and reasonable to the company. It would have to be shown that the price offered for the shares was far in excess of the actual asset backing of the shares, and also taking into account future business opportunities. If the offer is made at or around market price, in order to give an incentive to offeree shareholders to sell their shares back to the company, it is hard to see how the repurchase transaction could be impugned on the basis that the consideration offered was not fair and reasonable to the company.

If a takeover offer is by way of a stand in the market or other public mechanism then there will be no problem with the Board certifying the third limb, i.e. that it is not aware of inside information. However, if the Board gets wind of a creeping acquisition or an otherwise covert attempt to gain a foothold platform from which to launch a full bid, then it clearly, in good conscience, could not certify under the third limb. Again, the practical reality is that it would be extremely difficult to prove that the Board did have such knowledge of an attempted covert incremental takeover. It is submitted that it would not be enough to show merely that the Board had access to detailed information from the Share Register on recent acquisitions. Shares can be purchased through nominees, and most often are in the case of the initial stages of a takeover where a foothold platform is put together. The Board could quite easily appear disingenuous and deny that the reason for going private was in response to a perceived threat of takeover. Rather, it would be pitching the going private transaction as a means of lowering the company's operational expenses by delisting.

The second method to consider is that available under section 60(1)(b)(i). Because of the necessity for unanimous shareholder consent to be obtained, a public company with a dispersed and diverse shareholding would never be able to satisfy this requirement.

The third possibility for effecting a going private transaction would be a special offer under section 60(1)(b)(ii). The ability to make a targeted purchase must be contained in the constitution, and the requirements of section 61 also apply.

It will be recalled that under the special offer procedure contained in section 61 the Board must, in addition to the resolution required by section 60(3) (discussed above), also have resolved that:

(i) the acquisition is of benefit to the remaining shareholders; and

(ii) the terms of the offer and the price is also fair and reasonable to the remaining shareholders.

In a going-private transaction these two requirements will be met, at least in respect of the remaining majority insiders, if not the remaining minority who will inevitably face the prospect of being frozen out later or facing a coerced sale sooner at an unfavourable price. The potential for abuse rather runs in the other direction where shares are acquired by insiders at an undervalue from offeree shareholders.

Section 61(8) provides that a shareholder or the company may seek injunctive relief on the basis that the above requirements are not met. However, it will be clear from the above discussion that given the de facto shield of the business judgment rule, it is submitted that it would be very rare indeed for injunctive relief to be successful.

The final hurdle under the special acquisition procedure is the requirement under section 61(5) that before an offer is made the company must send to each shareholder a disclosure document complying with section 62. Section 62 requires disclosure of:

(a) the nature and terms of the offer and the identity of any specified shareholders; and

(b) the nature and extent of any relevant interest of any director of the company; and

(c) the text of the resolutions required by section 61, together with any such further information and explanation as may be necessary to enable a reasonable shareholder to understand the nature and implications for the company and its shareholders of the proposed acquisition.

The necessity for the disclosure document to provide the text of the section 61 resolution together with all further information and explanation should, in theory, prevent the special offer procedure being used in a situation where an inside group is seeking to capture future profits for itself.

It has been argued that the disclosure document required by section 61(5) and section 62 is inadequate to fully and fairly inform shareholders. Reference is often made to the extremely detailed requirements of rule 13(e) of the Securities and Exchange Code in the United States. However, an alternative view is that the very breadth of the third limb requirement in section 62 would encompass all of the matters covered by rule 13(e) and perhaps quite a number of others. After all, the third limb is expressed so that what must be achieved by a Board is a fair and balanced picture, taking into account all relevant material, to enable a reasonable shareholder (whatever that means) to assess whether or not they should take up the offer to sell their shares. If properly complied with, this is an extremely onerous requirement and would foreclose exploitation of the special acquisition procedure for motives such as those posited above. The reality would probably be very different.

On its face, the requirement to send the disclosure document to each shareholder would not make the section 61 procedure viable for a major listed company with a dispersed shareholding. This would be the case, particularly if the going private transaction was in response to a perceived threat of takeover, where speed in defence is necessarily of the essence. In this regard section 61(6) should be noted. The offer must not be made until at least 10 days have elapsed since the section 61(5) disclosure document has been sent to all shareholders.

Also, and more critically, to be an effective defensive option the special offer procedure must be capable of being made on market so that the company is able to raise its bid price in response to a raise in its rival's offered price.

If a disclosure document contains a fixed price, as it logically must, in relation to an off market special offer, then any time the rival raised its bid a fresh offer document would need to be prepared and sent out to all shareholders! This would not be administratively possible for most large public companies.

Section 62(a) requires the disclosure document to set out, inter alia, "the terms of the offer". If this means a fixed stated price then the on-market procedure would not be feasible because all the rival would have to do would be to raise its price, requiring the target to send out another disclosure document. However, if the price can be stated as falling within a fixed range of prices when the offer is to be effected on-market then the procedure is feasible because the company can vary the price of its own bid to better its rival's offer.

It is submitted that the better view is that a fixed price must be stated, given that the safeguards built into the special offer procedure are designed to prevent bail-outs at overvalue by insider shareholders or their associates.

Given that in a takeover bidding context a premium over market price will always be paid, and on-market purchases will be executed by the exchange's anonymous order-matching system there does not appear to be any possibility of this type of specific bail-out abuse being successful. The whole purpose of the special offer repurchase as a takeover defence is to achieve acceptances for a sufficiently large number of shares to repel the takeover bid from whoever is willing to accept the offer.

By effectively preventing such special offers being made on-market the rules relating to special offers operate in the takeover contest situation to prevent shareholders from receiving the maximum premium available.

The remaining procedure available for a going private transaction would be an on market offer under section 63. The analysis under section 63 is

similar to that undertaken above in relation to section 61, except that what requires to be resolved under section 63(1)(b) and (c) is that the acquisition is in the best interests of the company and its shareholders and that the terms of the offer and the price offered are fair and reasonable to the company and its shareholders. In effect, the requirements of section 60(3)(c)(ii) and section 61(1) are fused where a section 63 on-market offer with prior notice to shareholders is involved.

This picks up the point made above that in a going private transaction there is going to be no doubt at all that the transaction will be fair in all respects to the remaining (insider) shareholders. However, it is quite another matter for a Board to certify that the transaction is in the best interests and fair to all shareholders, i.e. remaining and exiting shareholders. This certification requirement should preclude a Board from proceeding with an on-market selective purchase where the strategy is to garner future profits for a small insider group of shareholders, but for the reasons given above will almost certainly be an ineffective deterrent to malpractice.

Section 63(8) provides a similar procedure to that provided in section 61(8), whereby injunctive relief can be sought by either a shareholder or the company. Due to the institutionalised imbalance in information available to insiders and outsiders it seems highly unlikely that a shareholder will have the requisite knowledge to impugn the resolutions. The only real possibility of injunctive relief succeeding would appear to be a proceeding brought on behalf of the company by an independent director who was aware of what the insider group was intending to achieve. This comment applies equally to the analysis under section 61.

In this regard it is interesting to note in passing the recommendations contained in a recent Australian publication entitled Strictly Boardroom[5] which recommended, inter alia, that an "ideal" board for a public listed company would comprise the following:

(a) non-executive chairman;

(b) six directors, majority non-executive;

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[5] Business Library, Frederick G Hilmer, Chair, 1993; in The National Business Review, 30 September 1994, Special Report: "Professional Directors: Endangered Species"

(c) audit committee comprising non-executive directors.

The whole thrust of this publication is the necessity to, wherever possible, have a majority of professional independent directors on the Board of public companies. If this is in fact achieved, then all of the abuses outlined in respect of going private transactions should be curtailed because executive directors (management insiders) would not be able to achieve the necessary majority to pass the resolutions required to effect abusive transactions. The independent external scrutiny of a majority of non-executive directors should provide a powerful disincentive to an insider management group to seek to abuse its position by profiting from its insider status.

Finally, once again before the offer is proceeded with on market, the disclosure document must be sent to each shareholder (section 63(6)). The same comments about the impracticability of such a requirement for a large public company with a dispersed shareholding applies equally in the context of a discussion of section 63.

A further point to note under sections 60, 61 and 63 is the requirement for the Board to resolve that the transaction is, inter alia, in the best interests of the company. In the context of an offer to repurchase, whether it be a pro-rata offer, a selective offer, or an offer to all shareholders on market, there is an essential ambiguity in the use of the term "company". It seems reasonably clear that sometimes the term "company" is intended to mean something different than the interests of the shareholders in their entirety. This follows from the fact that in section 63 (on market offer to all shareholders subject to notice requirements) the terms "shareholders" and "the company" are used cumulatively. It therefore follows that the two terms must be intended by the architects of the Act to mean different things, but just what that difference is is elusive.

In the context of a special acquisition, the transaction must be in the best interests not only of the company, but also in the best interests of the remaining shareholders. So, in this context company can only mean something other than the remaining shareholders. Logically, it can only

mean the exiting (selling) shareholders and the company entity as a going concern.

In relation to a pro-rata offer no group of shareholders is identified, and only the best interests of the company test must be satisfied. Since a pro-rata offer contemplates that, if the offer is taken up in a true pro-rata manner, that the relative ownership participation and thus voting rights will remain unchanged, the likely interpretation of the term "company" in this context is the company as a going concern or entity. However, this does not take us very far logically. The company is merely a juristic entity and it does not, it is submitted, take an analysis of the term any further forward in any meaningful way. What does the term "company" add to the term "all shareholders"?

These ambiguities aside, it is also important to note that where the term "company", or "(all) shareholders" is used in the context of a best interests test, it is oversimplistic to regard the interests of all shareholders as being identical. Where one is driven by logic to equate the interests of the company with the interests of all shareholders (as in the pro-rata offer context) then the same caution applies. In a going private transaction, the above analysis has demonstrated that the interests of the remaining (insider) shareholders will be very different from the interests of exiting (outsider) shareholders. The potential in the going private transaction for insiders to exploit their special knowledge and control of management mechanisms means that it will be in the interests of the remaining (insider) shareholders, and thus the company, that the shares of the offeree shareholders be acquired at the lowest possible price. This will enrich the remaining shareholders because the assets of the company used to acquire the departing shareholders' shares will bear a disproportionate relationship to the diminution in the overall value of the enterprise.

Conversely, it is in the interests of exiting shareholders to receive the highest price possible for their shares. As they will have no further immediate contact with the company as investors, their preference would be for a transfer of wealth to themselves at the expense of the company and, of necessity, the remaining shareholders. The complexities necessarily increase where there are different classes of shares, where class

rights are to be altered or where new classes of shares with different rights attaching are in contemplation of issue by the Board.

It is beyond the scope of this paper to investigate these issues further, and it is sufficient for the writer's purposes to note that in a repurchase transaction shareholders cannot be treated as a homogenous group. It is their very heterogeneity that provides the impetus for many common (if potentially abusive) repurchase transactions.

Draft Takeovers Code

A final draft Takeovers Code was released by the Takeovers Panel Advisory Committee established under the Takeovers Act 1993 in December 1993.

The draft Code's provisions must also be considered in the context of any discussion of going private repurchases intended either as takeover defences, or to capture control for insiders in circumstances where there is no takeover offer pending.

Essentially the draft Code provides the fundamental rule in Rule 4 that, subject to certain exceptions, a person who holds less than 20% of the shares in a listed company cannot increase that shareholding to more than 20%, and a person who holds 20% or more of such shares cannot further increase that shareholding unless the increase is made pursuant to an offer made in compliance with the Code.

An offer under the Code may be either a full offer for all of the shares (Rule 6), or a partial offer (Rule 7), but in either case the same terms should be offered to all shareholders of the same class (Rule 10) and, in respect of a partial offer, the offer must be pro rata. Where the maker of a partial offer controls less than 50% of the voting shares then the partial offer must be for a sufficient number of shares to give the partial offeror more than 50% control, unless a lesser percentage is approved by a resolution of the target company in general meeting.

On its face Rule 4 would catch insiders in going private transactions where either as a result of the insider's non take-up of a pro-rata offer of

repurchase, or a successful selective repurchase or repurchases, that insider's shareholding goes beyond the 20% threshold. For example, an insider director holding 20% of the company's shares could cause the company either by a pro-rata or selective offer alone, or by a combination of the two methods, to acquire half of the company's outstanding shares. If there were 1,000 shares before the repurchase programme, with the insider director holding 200 of them, the company's acquisition of half the balance (400) would leave a total of 600 shares. The insider director's percentage holding would have increased from 20% to 33.3%, and Rule 4 would require him or her to make either a full or partial offer. If a partial offer is chosen, then because less than 50% of the voting rights are held, the partial offer must take the offeror over the 50% threshold.

The Code's application to going private transactions is reinforced by the commentary to an earlier draft of the Code which confirmed the drafters' intention that Rule 4 may be breached by "involuntary", or indirect, increases resulting from repurchases. This raises the issue of whether going private transactions motivated by either of the reasons posited above will be possible unless the insiders are prepared to fund a partial offer for the balance of shares necessary to take them to over a 50% holding from their own resources (or from the company's resources using the financial assistance provisions) or make a full offer, and if 100% acceptance is achieved (or at least 90% to trigger the compulsory acquisition provisions of Rule 4.8 of the NZSE Listing Rules), use the section 107 unanimous agreement procedure to concur, after the event, to the provision of financial assistance otherwise than in accordance with sections 76 to 80 (section 107(1)(e)).

<u>NZSE Listing Requirements</u>

In the example given above in relation to the draft Takeovers Code, issues would also arise under the new NZSE Listing Requirements.

Essentially, the new stock exchange rules provide for compulsory "Notice and Pause" requirements (Rule 4.5) in relation to "restricted transfers" of shares. A restricted transfer is one which would result in control of votes by any person, or group of persons who are associated persons, exceeding 20% of the votes for any particular class of shares, or, if a holding is above

the 20% threshold, would result in an increase of more than 5% in any 12 month period.

The notice and pause requirements are intended to provide a period before which any restricted transfer becomes legally binding. The notice to the Exchange must include, inter alia, the price or consideration (expressed as a range if it is not fixed), any conditions which may be material to an assessment of price by prospective sellers, the maximum number of shares and percentage to which the transfer proposal relates, the identity of likely transferees and the number and percentage of shares likely to be held by them.

There is a 15 business day pause period if the prospective transferees are insiders, and a 3 business day pause period if they are not.

These notice and pause requirements are clearly designed to give other prospective bidders an opportunity to mount rival bids which are superior to the original bid. In this way it is hoped that a takeover bidding contest will develop such that shareholders in the target company ultimately receive the best price for their shares if they decide to accept an offer.

In relation to the going private transaction discussed under the draft Takeovers Code, the notice and pause provisions would clearly apply, to give other rival bidders an opportunity to up the ante. The consequence for an insider management group is that these provisions will prevent it acquiring control for a price less than a rival bidder may be prepared to pay. Essentially, the repurchase transactions which would increase the insider's shareholding beyond the 20% threshold are automatically subjected to the notice and pause provisions and can be negated by a higher offer.

The going private bid may still succeed, but the price the company must pay to go private may have to be significantly increased to top rival bids.

Consequently the notice and pause provisions should have the desirable effect of ensuring that exiting shareholders, through any ensuing bidding contest, receive the best possible price for their shares at that time.

(b) Australia

In the context of a going private transaction the provisions in relation to public listed companies need to be considered. Though the provisions of the Corporations Act 1989 relating to share buy-backs do not contain the specific resolution and certification provisions contained in the Companies Act 1993 (NZ), i.e. in relation to the transaction being in the best interests of the company and/or the company and its shareholders, and/or the company and the remaining shareholders, directors in Australia are under the same common law fiduciary duties to act in the best interests of the company as apply in most Commonwealth jurisdictions. For this reason the commentary contained in this paper in relation to the New Zealand provisions is also applicable in the Australian context, and will not be repeated here. Rather, the daunting mechanics involved in the various share repurchase options for public companies will be considered, as they impact on the viability of each method of proposed buy-back.

A critical limitation to a going private transaction, whether the going private transaction is to be effected by a buy-back scheme, an on-market purchase programme, or a selective buy-back, or any combination of these methods is that section 133EA provides an absolute limit on the number of shares that can be purchased in any 12 month period. That limit is 10% of the outstanding shareholding. In these circumstances, it is submitted that a going private transaction often could not be effected within a viable time period to achieve the objectives identified above in relation to such a transaction where going private is intended as a vehicle for insiders to gain control out of the company's assets and secure future benefits exclusively for themselves. In relation to an attempt to go private as a takeover defence, the 10% limit will defeat this strategy in most cases, thus depriving shareholders of the opportunity to receive a higher price from the company than from the takeover offeror. In this respect the New Zealand provisions are more flexible than the Australian provisions.

If enough shares can be purchased by the company it may no longer meet the Stock Exchange's listing requirements. ASX rules 1A(3), and 3J(9) prescribe the spread requirements for shares to retain their listing status. ASX rule 1A(3)(b) provides that a company seeking a Official Quotation of shares may be considered for admission to the Official List (and by

implication remain listed) if, inter alia, there are at least 500 shareholders, each with a parcel of shares having a value of at least $2,000.

The closer to the minimum spread requirements a company is then the easier it will be to effect a going private transaction within the 10% acquisition ceiling. Many companies however will exceed the spread requirements by such a margin that the 10% in 12 months limit would prevent anything but a slowly "creeping" inside takeover.

In relation to an off-market buy-back scheme (which in effect is a proportional offer to all shareholders like a Part A takeover offer) then, pursuant to section 133GA, the offers under the buy-back scheme can only be made after an ordinary resolution of the company has been passed, if the Board is aware that there is a takeover offer pending.

In addition, the notice of resolution required to be sent out to all shareholders entitled to vote on the resolution to make offers under the buy-back scheme must set out the "takeover" aspects of the proposed resolution (inter alia) (section 106GD(4)).

"Takeover aspects" is defined in section 133BF. Subsection 1 of that section provides that a notice that sets out the intention to propose a resolution of a company sets out the takeover aspects of the proposed resolution if, and only if, the notice complies with the section. The notice must set out whether or not any of the company's directors is aware of:

(a) a proposal by a person:

(i) to acquire, or to increase the extent of, a substantial interest in the company; or

(ii) without limiting the generality of sub-paragraph 1, to make a takeover bid in relation to the shares of the company; or

(b) a takeover bid that has been made by a person in relation to shares in the company and offers under which remain open as at that time.

Under section 133F(3), if any of the directors is aware of any such takeover activity the notice must set out whether or not such a proposal or takeover bid has influenced the decision to propose the resolution, and, if it has, particulars of each proposal and takeover bid concerned, and the extent to which each has influenced that decision.

The purpose of this notification requirement is to make shareholders aware that a third party is interested in acquiring shares in the company. Against this background of competition for their shares, shareholders will view any offer for their shares by the company very differently than if they were unaware of an alternative offer. The rule is designed to assist willing sellers to achieve the best sale price for their shares.

It is submitted that since a going private transaction is in effect a method of internal takeover by a management or management/shareholder aligned insider group, then there would be a necessity for takeover aspects to be included in the notice of resolution sent out to all shareholders entitled to vote. This situation seem to fall squarely within the words of the second limb of section 133BF(1)(a)(i), at least in circumstances where a substantial interest was held by any insider and the purpose and effect of the going private transaction necessarily would be to increase the extent of that substantial interest as a result of repurchased shares being cancelled and thus increasing the insiders' proportionate stake in (and control over) the company. If this was complied with to the letter by the insider/insider management aligned group, then, in the absence of reasons or rationalisations that were persuasive to shareholders that the price offered to them was fair, then it is unlikely that a sufficient majority of votes could be solicited to pass the necessary resolution.

Section 133GD(9) also requires the directors to set out in the notice all other information that is known to any of the directors and may reasonably be expected to influence a person in deciding whether or not to vote in favour of the resolution. As has been seen above, a similar provision is contained in the New Zealand provisions, and if complied with should prevent the passage of the resolution unless the reasons given are sufficient to persuade offeree shareholders that it is in their best interests and the best interests of the company that the transaction proceed.

In relation to a selective buy-back, a special 75/75 super majority must vote in favour of the selective buy-back (section 133JA). Once again, a notice must be sent to all shareholders entitled to vote on the resolution that the selective buy-back proceed, and the notice must contain the reasons the buy-back is being proposed and the facts and principles underlying those reasons (section 133KH), and also the takeover aspects of the proposed resolution (section 133KH(ii)). In addition section 133KJ requires the notice to set out what the directors consider will be the likely effect on the company's state of affairs if the proposed buy-back is made, and a declaration of solvency must also be contained in the notice. An expert's report that the offer is fair and reasonable must also be provided by an independent expert, and, if there is an element of non-cash consideration included, the opinion of two independent experts is required that that non-cash consideration portion of the offer is also fair and reasonable. Clearly these expert certification requirements will add significantly to the time and expense required to progress any affected repurchase transaction.

Additionally, section 133KK requires that the notice must set out, in relation to each of the directors, any associated person of that director, and also a director's disclosure of interest. The notice must also set out what the directors will consider will be the likely effect on the control of the company if the proposed buy-back is made, and also in relation to each of the directors whether they consider that if the proposed buy-back were made, and the shares were cancelled immediately afterwards, the director would be entitled to more than 20% of the shares in the company, and if so, the respective percentages to which the directors consider it likely that they would be entitled (section 133KL). The impact of these disclosure requirements on a proposed going private transaction are obvious. They have been designed to ensure that there is transparency in relation to directors' motives and the effect that a selective repurchase would have in relation to any increase in directors' control of the company if the buy-back was to proceed.

Finally, section 133KM requires the notice to set out all other information that is known to any of the directors which may reasonably be expected to

influence a person in deciding whether or not to vote in favour of the resolution.

These comprehensive requirements, which are designed to provide to shareholders entitled to vote the full picture of the motivations and likely effect on the purchase, should, if complied with, prevent an abusive going private transaction proceeding. If the reasons for a bona fide going private transaction (as discussed above in the New Zealand section) are in fact present, then the extensive notice requirements should not prevent such a going private transaction proceeding.

However, in relation to a hostile takeover bid, and the proposed use of the buy-back procedure to mount a defence, the periods of notice required will usually prevent the company acting quickly enough to mount an effective defence, and the 10% repurchase limit will firmly nail the coffin lid down.

Once again a creditor's objection procedure, similar to that applying to a buy-back scheme, applies in the case of a selective buy-back, with the consequences discussed.

It is submitted that in certain circumstances the going private transaction is viable under the Australian provisions. The procedural safeguards are complex, lengthy and cumbersome. But, if there is no particular requirement for haste, and great care is taken, these requirements can be complied with. However, in the very situation, such as a hostile takeover offer which the directors honestly and reasonably believe not to be in the best interests of the company, the delays in relation to the selective buy-back procedure created by the notice requirements, the necessity for the 75/75 special resolution, and the 10% repurchase limit will frustrate a takeover defence based on the selective special offer procedure, and thus deprive shareholders in the target company of the opportunity to receive a higher price for their shares than offered by the raider. It is ironic that a legitimate use of the special offer procedure to take a company private in order to protect the best interests of the shareholders cannot be effected under this procedure.

3. CAPITAL MARKET ARBITRAGE TRANSACTIONS

(a) New Zealand

The ability for a company to repurchase its own shares on a regular basis on market provides a method by which the company can make regular or periodic adjustments to its funding/gearing ratios (debt/debt plus equity ratio). In order to minimise the cost of capital, a rational company will seek to have a higher proportion of its funding through debt securities rather than equity securities when the interest payable on the debt in net terms is less than the cost of maintaining the equity capital in terms of dividend payments and shareholder servicing requirements.

Clearly, this is a very wide generalisation, because in some circumstances the maintenance of a company's share price will depend upon that company's dividend payout policy. Rather than risk a loss of market confidence in the company's shares by announcing a no-dividend or a reduced dividend policy, a viable alternative for a company may be to reacquire a proportion of its shares on market and thus reduce the number of outstanding shares in respect of which a dividend must be paid. If debt is relatively cheap, then funds may be borrowed to fund the acquisition of the shares, and the consequent reduction of equity capital.

This type of ongoing gearing adjustment system can be regarded as a normal part of good and prudent company management. However, such a regular programme of on market purchases can also be used to maintain the share price by keeping the market in that company's shares active and thus giving an illusion that the shares are in more demand than they actually are. By making significant and regular purchases of its own shares, a company can give a buy signal to the market. The market may then price the shares at a premium to what could be regarded as the "true" value that those shares should command. This so called "ramping" of share prices by the artificial expedient of self purchase is generally regarded as an abuse of the share repurchase mechanism.

Because the mechanism to achieve both legitimate gearing requirements and share price maintenance is the same, it will be essential for a Board engaged in legitimate gearing adjustments to have a clear financial plan

which can be audited externally in order to deflect any accusation of share price maintenance simpliciter. This is particularly necessary since no "safe harbour" provision (such as Rule 10b-18 under the Securities Exchange Act 1934 (U.S.A.), which guarantees immunity from allegations of share price fixing if purchases are limited as to method of acquisition, timing, price and volume) has been included in the Companies Act 1993.

It is clear that the resolution and disclosure requirements contained in section 63 are intended as safeguards to prevent abuse of on-market purchases to manipulate share prices or to create an impression of trading activity in the shares. However, as will be seen below these requirements will undoubtedly have the effect of preventing companies from engaging in legitimate programmes of ongoing gearing adjustment by on-market purchases.

Quite simply, the repurchase provisions in the Companies Act 1993 are not designed to cope with issuer intervention on a regular basis. Any such attempted intervention in the market under section 60(1)(a) appears to require management to make an offer to all shareholders every time it intends to intervene in the market. Similarly, intervening under section 60(1)(b)(ii) would require the sending of a disclosure document to all shareholders (section 61(5) and section 62), and also there is a ten day moratorium imposed before any repurchase can be made (section 61(6)). Both of these requirements make regular on-market interventions completely impractical.

In the absence of any intention to manipulate share prices, such regular interventions for legitimate gearing and adjustment purposes are frustrated by formalities and constraints which address abuses that are absent from this particular type of transaction.

In short, the pro-rata offer procedure and the special offer procedure under section 61 have been designed in part to include protections against share price manipulation. However, in order to prevent this type of abuse, the protective mechanism adopted in the legislation is designed so that it also prevents legitimate exercises of the power. It could be said that the cure is so drastic that it has killed the patient.

To recap, the 1993 Act contemplates four principal kinds of offer by a company to purchase its own shares:

(1) a pro-rata offer to all shareholders;

(2) a selective offer directed to some shareholders;

(3) an on-market purchase of shares with prior notice to shareholders; and

(4) an on-market purchase of shares without prior notice to shareholders

(sections 59(2), 60, 61, 63, 65).

Each of these permitted methods of acquisition involves the company making an offer to buy shares after satisfying certain formal requirements.

It does not appear that an ongoing gearing adjustment programme of repurchase can be effected through the pro-rata offer procedure. Since this type of programme will only be undertaken by large listed companies, the only way to implement such a programme would be through a sharebroker or brokers. Brokers operate by pooling buy and sell orders and matching these orders to effect sale and purchase transactions. In these circumstances it is impossible in any given transaction to say who the seller is, because the acquired shares come from a homogenous pool. So, the requirement under section 60(1)(a) that the offer is "an offer to all shareholders to acquire a proportion of their shares" could not be complied with.

Even if the company undertook an extensive advertising campaign in an attempt to notify all of its dispersed shareholding that the company was making such a pro-rata offer, because of the way that brokers pool buy and sell shares described above, there is no way for an instructed broker or brokers to ensure that acceptances of the offer to purchase are implemented in a pro-rata manner, so that only the required portion of shares is purchased from each shareholder, and also where less than the ceiling

percentage of shares is tendered for sale by a shareholder that any shortfall is rateably distributed amongst other willing sellers.

Aside from these problems, an on-going capital arbitrage programme may require daily, relatively small, interventions: a strategy for which the pro-rata offer procedure, with its necessity to send an offer document to each shareholder and the requirement for a sufficient delay to afford a reasonable opportunity to accept the offer (section 60(1)(a)(ii)) is uniquely unsuitable.

The second possible method of implementing such a gearing adjustment programme is through the special offer procedure. The problems created by the broker's pooling method described above would not apply in the case of a special offer under section 60(1)(b)(ii) because sales and purchases from a pool could be described as "an offer to one or more shareholders". However, section 61(5) requires that a disclosure document be sent to each shareholder before the offer can be made and a minimum 10 day "fallow period" applies from the day the disclosure document is sent. This is a cumbersome and expensive procedure. There does not appear to be any advantage in utilising the special offer procedure, in preference to the on-market purchase with notice procedure set out in section 63.

The two most obvious methods to effect an ongoing gearing adjustment programme are those contained in sections 63 and 65.

Section 63 provides that the Board may make offers on a stock exchange to all shareholders to acquire shares. The Board must first resolve pursuant to section 63(1) (and effectively the same, under section 65(1), except that the Board certifies as to compliance with the 5% in 12 months ceiling, rather than as to acquisition of no more than a specified number of shares):

(1) to acquire not more than a specified number of shares; and

(2) that the acquisition is in the best interests of the company and its shareholders; and

(3) that the terms of the offer and the consideration offered for the shares are fair and reasonable to the company and its shareholders; and

(4) that it does not have any inside information.

Where the purpose of repurchase is on-going gearing adjustment a Board should be able to certify as to these matters, without too much difficulty, though caution will always have to be exercised in respect of the resolution as to the absence of inside information.

Sections 63 and 65 also require resolution and certification as to solvency.

Any offer must be withdrawn if the number of shares to be acquired (together with any shares already acquired by the company) would exceed the maximum number of shares the Board has resolved to acquire (section 63(4)).

Under subsection 5 the Board must withdraw the offer if after the passing of the resolution under subsection 1 and before making the offer it ceases to be satisfied that the acquisition is in the best interests of the company and its shareholders, or it ceases to be satisfied that the terms of the offer and consideration are fair and reasonable to the company and its shareholders, or it becomes aware of inside information.

Subsection 6 requires that a disclosure document, in similar terms to that contained under the special offer procedure in section 61, be sent to each shareholder before the offer is made. The offer can remain open 12 months after the disclosure document is sent to each shareholder (section 63(8)).

It is interesting to note that in terms of section 64(2), the consideration the Board proposes to offer to acquire the shares does not have to be included in the disclosure document. On first reflection this seems quite a bizarre omission, as price is the most important piece of information that a prospective selling shareholder would want to know. The rationale for the inclusion of this provision may be that there was concern that if a company was required to disclose its uppermost price, or a range of prices, then

prospective sellers would be aware of the upper limit that the company was prepared to pay, and therefore the price would naturally gravitate up to that level. This would inevitably result in the company paying more for the shares than it would have to if the normal supply and demand rules that operate on the market prevailed. The writer can think of no other reason than this for the provision.

It is submitted that a Board could not, in good faith, certify that the offer was in the best interests of the company and shareholders if it also had to show its hand by disclosing the top price that it was prepared to pay. It cannot be in the best interests of a company to signal in advance to its shareholders the range within which it will make offers, or the price ceiling, because the market is likely to move to the top of that range, and the company (in effect the remaining shareholders) will pay more for the shares purchased than would otherwise be the case.

Acquisitions under section 63 are not subject to an annual limitation such as the 5% ceiling in any 12 month period which applies under the section 65 procedure. Shareholders do not have to be notified in respect of each individual transaction, with the disclosure document only having to be sent once, and remaining valid for a period from ten days after the offer is made out to 12 months as the window within which the transactions can be effected.

A major problem with an onmarket acquisition under section 63 is the fact that section 64(1)(c) requires the nature and extent of any relevant interest of any director of the company in any shares that may be acquired to be stated in the disclosure document sent to all shareholders. While it will be possible for directors to provide this information at the time of the offer, circumstances will almost certainly change over the intervening 12 month period so that the facts stated under limb (c) of the disclosure document are no longer true. Such changes in relevant interests could occur, most simply by a sale or purchase of shares by a director, or, by falling foul of the related-party transaction requirements, so that if a company in which a director held a 20% stake acquired shares or sold shares in the company, then necessarily the director's relevant interest would also change.

Though it is not stated anywhere explicitly in section 63, a reading of the section which seems to best give effect to the policy behind the repurchase provisions would be that the disclosure document should always be accurate and up to date in order to fully inform shareholders. If this is a correct interpretation of the section, then in terms of sub-section 6, before any further offer is made the company should send to each shareholder a disclosure document that complies with section 64. Any change in circumstances would render a previously sent out disclosure document inaccurate and, ipso facto, would not comply with section 64 because it would be inaccurate. In these circumstances a sensible interpretation is that no further offers could be made under the repurchase programme until a further amended disclosure document had been again sent to all shareholders, which reflected the current and accurate interests of directors.

The company would then have to wait a further ten days after the updated and amended disclosure document had been sent to shareholders before it could make another on-market purchase. Given the sanctions that can be visited on directors under the Act for a breach of any of the requirements, it would be a very brave director indeed who would agree to regular on-market purchase programme, unless he or she, was, at any point in time, able to establish with perfect accuracy his or her shareholding, or the shareholding of any related party. In many cases, and the problem is exacerbated with larger boards, this will be neither practical nor possible.

The final possible method of implementing an ongoing gearing adjustment programme is under the provisions of section 65. Section 65 provides for stock exchange acquisitions which are not subject to a prior notice to shareholders requirement. However, the main drawbacks with the section 65 procedure are that the amount that can be purchased in any 12 month period is not to exceed 5% of shares in the same class as those being acquired as at the date 12 months before the acquisition of the shares. In many cases the 5% ceiling will be too low to sit with a fairly regular series of purchases, and would not be used for this reason.

A further problem under section 65, as originally enacted, before it was amended by the Companies Act 1993 Amendment Act (No. 1) (assented to 27 June 1994, to have effect from 1 July 1994) was that sub-section (2)

required a disclosure document to be sent to each shareholder within 10 working days after shares were acquired under the section.

The ten day disclosure requirement would have been extremely expensive and impractical, particularly where regular market interventions are the norm, and where transactions are perhaps concluded on a daily basis. For large publicly listed companies such as Telecom, Fletcher Challenge and Brierly it would simply not be administratively possible to conduct an ongoing market purchase programme under these conditions.

The Amendment Act ameliorates this problem by requiring that notice of any purchase must be given to each stock exchange on which the shares are listed within 10 working days of each on-market acquisition and all shareholders must be notified within three months of each acquisition of the matters specified in section 65(2). So, the necessity to notify all shareholders of each acquisition is enlarged from a ten day time period to three months. This should enable a number of regular purchases to be notified in the same notice. While this ameliorates the problem with the original section 65(2) it clearly still involves an arguably unnecessary significant additional transaction cost. It is suggested that the requirement to notify the stock exchange is all that is required and the requirement to notify all shareholders (even quarterly) is unnecessary and should be dispensed with.

As originally enacted, section 65(2)(d) also (if ambiguously) required (inter alia) the identity of the seller of shares to the company, to be stated. By virtue of the market's order-matching system this was impossible. This defect has now been cured by the Amendment Act by rewriting section 65(2)(d) to make it clear that the identity of the seller only needs to be notified to the stock exchange and shareholders if it is known to the company.

From the above discussion it follows that the two methods of on-market acquisition which are available to effect an ongoing gearing adjustment, or price stabilisation programme, are practically inadequate. The delays and expense involved in complying with the various procedures means that they would rarely, if ever, be resorted to.

One identified abuse of share repurchase is the ability of directors to cause the company to buy out their own interests or those of their confedetrates at an inflated price. This has the effect of transferring wealth from the company to the exiting sellers. Another potential abuse is the purchase of those interests at a fair price, but in circumstances where there are few buyers for the company shares, so that those who wish to exit from the company may be denied the opportunity to do so. Both of these abuses are far less likely to occur where purchases are made on-market by a listed company.

In particular, if the offer is made on the New Zealand Stock Exchange, the directors cannot control to whom the offer is made, and the company's offer to buy can be accepted by any shareholder willing to sell at that price. The company is unable to orchestrate who the originator of a sell order it accepts might be.

Given these circumstances, and the fact that boards of public companies are very much open to public scrutiny, and rely on their reputations in business for (inter alia) their income from future directorships, it would appear that a streamlined on-market purchase procedure could be devised which provides adequate protection to the company and shareholders.

It is submitted that an appropriate balance between the practical logistics of on-market buy backs and the need to keep shareholders informed of the company's presence in the market could be achieved by a modified notice requirement under which a company whose board had approved on-market buy backs would (in addition to the resolution requirements of sections 63(1) and 65(1)):

(1) give notice of that approval to shareholders no less than ten working days and no more than twelve months before effecting purchases; and

(2) would include in the notice the maximum number of shares to be acquired and the period during which their acquisition had been authorised.

This would inform shareholders that the company was in the market to acquire their shares. This notice protection is also bolstered by the prohibitions on trading by insiders in the Securities Amendment Act 1988, which should prevent directors, employees and those who obtain information from them from abusing the knowledge by selling their own shares, if no announcement has been made.

(b) New Zealand Stock Exchange Listing Rules

The above analysis of transactions under the Act provisions must be read in the context of the NZSE Listing rules. The new rules came into effect on 1 September 1994. Section 7 of the Rules deals with issues and buy-backs of securities.

Rule 7.6 of the NZSE Rules stipulates certain requirements in respect of buy-backs of equity securities and financial assistance. Rule 7.6.1 provides that an Issuer shall not acquire its own shares unless the acquisition (inter alia):

(a) is effected by offers made by the Issuer through the Exchange's order matching market or through the order matching market of a recognised Stock Exchange, and the Issuer complies with the prior notice of acquisition requirements contained in Rule 7.6.2; or

(b) is effected in compliance with section 60(1)(a) (read together with section 60(2)) of the Companies Act 1993. and the Issuer complies with the Rule 7.6.2 notice requirements.

What the rule appears to say is that a special offer can only be made on the Exchange through the Exchange's order matching (pooling) system, and a pro-rata offer must comply with the Companies Act 1993 requirements and also the notice procedure set out in Rule 7.6.2.

The apparent purpose of requiring that special offers by listed companies can only be effected on-market through the stock exchange's order matching system is to protect against the particular abuses noted immediately above, i.e. insider sale at overvalue to exit a troubled

company or to make a windfall gain, or to provide a method of guaranteed exit from a company for insiders or their associates in circumstances where there were few, or no, potential purchasers for the shares other than the company. The essential anonymity of the order-matching system would prevent such abuses occurring.

Rule 7.6.2 requires that before an issuer acquires its own shares pursuant to Rule 7.6.1(a), it must give a notice that:

(i) specifies a period of time within which the issuer will acquire the shares; and

(ii) specifies the class and maximum number of shares to be acquired or sold in that period; and

(iii) specifies the maximum price at which the shares may be acquired by the issuer.

The effect of Rule 7.6.1 is that special offers by publicly listed companies can only be made on-market, and subject to the notice requirements contained in Rule 7.6.2. As noted in this paper in relation to a discussion of section 64(2), the necessity to specify a maximum price which the shares may be acquired (Rule 7.6.2(b)(iii)) will militate against special offers made on-market for the reason that the company is signalling in advance the maximum price it is prepared to pay, and, in the normal course of events, the market price is likely to gravitate to this limit. This makes such an on-market purchase option unattractive, and it is submitted that the requirement in Rule 7.6.2(b)(iii) to disclose the maximum price could be deleted with no loss of protection for shareholders.

Rule 7.6.1(b) also requires pro-rata offers to be preceded by the notice required by Rule 7.6.2. However, that rule is expressed to be limited to acquisitions under Rule 7.6.1(a). On its face, these two provisions are inconsistent. Also, the requirement to specify the maximum price at which the shares may be acquired by the issuer does not sit easily with a pro-rata offer procedure where the exact price will be stated.

In addition, Rule 7.12.1 requires an issuer which buys its own shares to immediately give notice to the Exchange of details of the acquisition, including the class and number of shares acquired, their nominal value (if any) and the acquisition price, whether the payment was in cash, any amount paid up (if not in full), the percentage of the total class of share acquired, the reason for the acquisition, the specific authority for the acquisition (if any), any terms or details of the acquisition, and the total number of shares of that particular class still in existence after the acquisition.

The notice requirements of Rule 7.12.1 will provide considerable administrative problems where a large number of transactions are conducted by the company, whether on-market or off-market. The rule is phrased so that its ordinary meaning appears to be that such notice must be complied with each time there is an acquisition. In the case of regular purchases it will not be practical for a company to comply with such a post-acquisition notification requirement.

(c) Australia

The first point to note is that under section 133EA the absolute prohibition on a public company acquiring more than 10% of its outstanding shares in any 12 month period applies unless the buy-back is an employee-shares purchase or an odd lot purchase. In many instances a 10% limit may not be sufficient to run an effective ongoing gearing/capital costs arbitrage programme. Unlike in the case of proprietary companies under the Australian legislation, there is no provision in any circumstances for this absolute limited to be exceeded. This could be a major drawback for a public company seeking to set up such an ongoing on-market programme.

The problems identified with buy-back schemes and special offers, which are noted above, apply equally in the context of a continuing on-market purchase programme. Additionally, it should be noted in relation to a buy-back scheme (pro-rata offer to all shareholders) that section 133FB(7) requires that each such offer must specify the consideration that under the offer is to be provided for the buy-back of each share to which the offer relates. Where regular purchases are proposed to be made on-market, this requirement will never be able to be complied with because the share price

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will fluctuate and it is therefore impossible to specify the price in advance. The price at which the company will be prepared to purchase its own shares on-market will vary from time to time depending on market conditions and its financial requirements. Theoretically, a ceiling price could be specified, but this price would not meet the requirements of the section because it is not the price which the company is offering in all cases, merely an upper limit.

Section 133FB(11) also requires each offer to relate to a proportion of the shares in the company that the offeree holds and that proportion must be the same in respect of each offer. In Australia a pooling system similar to that operating in New Zealand operates in respect of on-market purchases, so, for the reasons given above, this requirement also cannot be met in relation to pro-rata offer on the ASX.

In practice, the pro-rata offer procedure would never be considered for such an on-going capital cost arbitrage programme because the essence of such a programme is that shares will be purchased from time to time at different prices from different shareholders, depending on the company's needs at the time.

It follows that any attempted ongoing on-market purchase programme will be conducted under the special offer procedure. In addition to the requirements identified in the previous section of this paper, the Australian Stock Exchange Listing Rules also provide specific requirements for on-market buy-backs. The applicable rule is Rule 3V. In essence, Rule 3V requires that a company proposing to establish an on-market buy-back scheme shall lodge a notice with its Home Exchange which provides the following information:

(a) that it is the company's intention to purchase its shares on-market pursuant to the provisions of the Listing Rules and that it has attended to all necessary requirements of the Corporations Law for this purpose;

(b) the number and description of the shares of the class on issue at the date of the statement, the maximum number of those shares the company would wish to acquire and the

percentage that the maximum number of those shares bears to the number of shares of the class on issue;

(c) the reasons the company wishes to purchase its shares;

(d) whether the company is the subject of a takeover offer or announcement, or whether any of the directors are aware that a takeover offer or announcement will be made for any of the securities of the company;

(e) whether any of the directors and/or their associates wish to reserve the right to sell shares on-market to the company and, the names of any such directors;

(f) the name of the Member Organisation (sharebroker) that the company will appoint to act on its behalf;

(g) that there is no information that would be required to be disclosed pursuant to the Listing Rules to the market that has not already been disclosed; and

(h) all other information of relevance to shareholders concerning the establishment or conduct of the on-market buy-back scheme.

Rule 3V(7)(b) prohibits the company from purchasing any of its shares at a price which is 5% higher than the average of the last sale price recorded on the Exchange on each of the last five days on which sales in the securities were recorded. This condition which is obviously intended to try to prevent shares being acquired from directors or their associates or other favoured persons at an overvalue, places an unnecessary restraint on the company's flexibility to purchase its own shares at the time and price that it deems prudent.

Under Rule3V(8)(c) and (d), it appears that the maximum time period that such an ongoing programme can run for is six months, before a fresh notice must be filed. Paragraph (c) puts a time limit of one month on each such buying programme, and also provides that the programme can be

extended with the extent of the exchange for a further period or periods of one month. However, paragraph (d) provides that the maximum period for which the programme can run with extensions is the initial period of one month plus five monthly extensions, giving a total of six months. Once again this requirement does not sit easily with a proposed ongoing on-market repurchase programme.

Rule 3V(9) requires that where the directors or the company are aware of an actual or proposed takeover offer or announcement, the company may not establish an on-market buy-back scheme unless the company, in general meeting by ordinary resolution, approves the establishment of the scheme, and where the notice of meeting also includes all of the information to be included in the notice to establish an on-market buy-back scheme required by Rule 3V(6). Again, this rule which is intended to constrain the use of self-purchase as a takeover defence unless a majority of the shareholders consent, provides an additional administrative hurdle that must be scaled in order to keep an ongoing on-market programme running, where monthly extensions are required under Rule 3V(8)(c) and (d).

Finally, Rule 3V(11) requires that where the company lodges a notice pursuant to section 133TB of the Corporations Law, it must immediately advise the Home Exchange, in respect of any purchase pursuant to an on-market buy-back scheme, the percentage of issued shares of the class which it has purchased and the total number of shares purchased at each price paid. Paragraph (b) requires that the Home Exchange be notified at the start of the following trading day when any directors and/or their associates dispose of shares in the company, and also the names of any such directors. The problems noted above in relation to the interests of directors changing, particularly through acquisitions or disposals by their associates or companies in which they have a significant stake (i.e. related parties), would make this requirement very difficult to comply with in the context of an ongoing on-market purchase programme.

As can be seen from the above analysis, while in some circumstances it will be possible to run an ongoing on-market purchase programme, the legislative and Stock Exchange requirements relating to any such programme are complex and administratively daunting. In particular, the

six month time limit on such a programme before the whole process has to be gone through again, is inappropriate, and the requirement to notify the Exchange where a director or an associate sells shares to the company will be often extremely difficult to comply with in practice. So, like their counterpart provisions in New Zealand, the mosaic of rules relating to a potential on-market purchase programme may well be effective to counter perceived potential abuses of the share repurchase power, but are completely impractical to facilitate a legitimate on-going gearing adjustment programme on a stock exchange.

6. CONCLUSIONS

The analysis undertaken in this paper has demonstrated that in relation to three transactions which are commonly associated with purchase of own shares in overseas jurisdictions, both the New Zealand and Australian legislative provisions which govern share buy-backs provide significant, and in some instances insuperable, difficulties to those transactions being undertaken in New Zealand or Australia.

In relation to buy-out agreements in closely held companies the above analysis has demonstrated that in New Zealand only one method of effecting such an agreement is available under the Companies Act 1993 provisions relating to re-purchase. This is a unanimous shareholder agreement under section 107(5)(a). This method is subject to the solvency test, which necessarily (and desirably) adds an element of uncertainty whether the agreement will be able to be performed at the relevant time. A buy-out agreement may also be concluded under the redeemable share provisions relating to shares redeemable at the option of the holder, or shares redeemable on a certain date. The advantage of the redeemable share method is that it is not subject to the solvency test. Rather, if the company is insolvent after the redemption then redemption amounts may be traced and recovered from departing shareholders. It is submitted that in many cases buy-out agreements will continue to be made under the redeemable share provisions, as they were before the enactment of the Companies Act 1993.

In Australia, the Close Corporations Act 1989 is not yet proclaimed to come into force. Before examination of its provisions, a reasonable expectation would be that this would provide a perfect vehicle for a buy-out agreement in a closely held company. However, upon examination, it does not appear that the Act provides such a method. Turning to the substantive share repurchase provisions in Division 4B of Part 2.4 of the Corporations Act 1989, neither the buy-back scheme provisions nor the targeted offer or employee share purchase provisions are suitable to effect buy-back agreements. Like their New Zealand counterparts, these provisions contemplate a repurchase in the near future, not the creation of a binding obligation to acquire shares of a departing shareholder at some time far into the future. It follows that since the share repurchase provisions are inappropriate to effect buy-out agreements, then the only acceptable option available in Australia will continue to be buy-out agreements effected using redeemable preference shares.

In relation to going private transactions in the New Zealand context, it has been demonstrated that the certification and notice provisions are unlikely to be effective to prevent abusive going private transactions where an insider management/shareholder group wishes to garner future profits of the business exclusively for itself. However, where the repurchase mechanism is used as a takeover defence, either alone, or as an integral part of a scheme to go private then there are real difficulties. The effects of hamstringing legitimate takeover defences is that the desirable auction feature whereby offeree shareholders through a bid and counter bid procedure eventually acquire the best possible price for their shares, is stymied. In these circumstances offeree shareholders will have little choice but to accept a partial takeover offer at a consideration which they may well consider to be unacceptably low.

In Australia the multitudinous and complex requirements of the repurchase provisions provide significant hurdles and difficulties to effecting a going private transaction. With great care, going private transactions can be effected by insiders, but legitimate takeover defences are likely to be hamstrung, in a manner similar to New Zealand, by the extensive notice and resolution requirements.

In relation to capital market arbitrage transactions, there are significant hurdles in New Zealand to an ongoing on-market programme being effected, with similar problems being encountered in Australia.

These difficulties flow from the fact that in both jurisdictions a prescriptive approach to the control of share buy-backs has been adopted, whereby the most commonly identified abusive features of share repurchase transactions have been identified (e.g. selective bail out at an overvalue, share price manipulation) and specific requirements included in the legislation to prevent such abuses occurring. A consequence of this approach is that while the requirements may well be effective to prevent the perceived abuses to which share buy-back can be put, they also have the effect of preventing, or making very difficult, common transactions whose purpose is entirely legitimate.

The New Zealand provisions appear deceptively simple on their face, but the above analysis has demonstrated that the legislation is rife with uncertainty and ambiguity in certain important respects. The Australian provisions are labyrinthine. One suspects that they will rarely be used, because of the very high risk of non-compliance either through confusion or genuine oversight. Also, in Australia directors must be responsible for solvency declarations for 12 months after they are made and are personally liable to indemnify the company for payments made to purchase the company's shares if insolvency occurs during this period. Directors are unlikely to be willing to exercise the repurchase power under these circumstances in all but a few cases.

The economic costs in having defective share repurchase regimes are legion. In New Zealand the ambiguities and inappropriate protective mechanisms which surround both potentially abusive, and legitimate transactions, are unnecessary and frustrating. The same can be said for the highly complex Australian provisions, which should come complete with a survival guide. However, the economic effects of such unsuitable regimes are not merely limited to added transaction costs. There are also significant indirect, and in many cases unquantifiable, costs, involved in foregone opportunities to take advantage of the procedure. Two clear examples which have arisen from the above analysis are the situation of the frustration of legitimate takeover defences, which will have the effect of

preventing offeree shareholders from receiving the best price for their shares, and also capital market arbitrage transactions, where legitimate ongoing on-market gearing adjustment programmes will not be able to be effected. The result is that companies will pay more for their funding requirements than would otherwise be the case if such an ongoing programme could be effected simply and with minimum cost and complexity.

These direct and indirect costs will be directly reflected in the competitiveness of companies who would otherwise seek to use the share repurchase mechanism to achieve legitimate business purposes. It is clearly no answer to say that alternative methods can be found to effect the transactions which would otherwise be achievable by share repurchase. The point is that inappropriate regimes have been implemented which foreclose the possibility of a more efficient use of corporate resources. In the global market-place, every company needs an edge. In New Zealand and Australia the share repurchase regimes function more as a hammer than a wet stone.

It is submitted that what is required to remedy the defects in the current provisions in New Zealand and Australia is not selected amendments (in the case of New Zealand) or massive simplification (in Australia). Rather, a less prescriptive approach which relies more on a reliance on directors' duties to act in good faith in the company's best interests and to act for a proper purpose, together with the further facilitation of shareholder remedies, is the preferable approach to adopt in relation to share repurchases. This is a case where it would be appropriate to throw out the bath water and the babies and start again.

7. APPENDICES

A. Matrix chart summarising New Zealand legislative conditions re share buy-backs

B. Matrix chart summarising Australian legislative conditions re share buy-backs

Appendix A

COMPANY BUY-BACKS UNDER COMPANIES ACT 1993 (NZ)

CONDITIONS TO BE SATISFIED

TYPE OF BUY-BACK

CONDITIONS	PRO-RATA OFFER (SECTION 60(1)(a))	TARGETED/ SELECTIVE/ "SPECIAL" OFFER (SECTION 60(1)(b))	ON MARKET PURCHASE >5%/12 (SECTION 63)	ON MARKET PURCHASE <5%/12 (SECTION 65)
Authorisation by Company Constitution	Yes s 59(1)	Yes s 59(1)	Yes s59(1)	Yes s 59(1)
Solvency Declaration	Yes s 52(2)	Yes s 52(2)	Yes s 52(2)	Yes s 52(2)
Shareholder's Best -Interest Declaration	-	Yes (remaining shareholders only() s 61(1)(a)	Yes s63(1)(b)	Yes s 65(1)(a)(i)
Company's Best Interest Declaration	Yes s 60(3)(a)	Yes s 60(3)(a)	Yes s 63(1)(b)	Yes s 65(1)(a)(i)
Shareholder Approval	-	All shareholders OR follow section 61 procedure s 60(b)(i) or (ii)	-	-
Fair and Reasonable to Company	Yes s 60(3)(b)	Yes s 60(3)(b)	Yes s 63(1)(c)	Yes s 65(1(a)(ii)
Fair and Reasonable to Company	-	Yes (remaining shareholders only) s 61(1)(b)	Yes s 63(1)(c)	-
"No Inside Information" Declaration	Yes s 60(3)(c)	Yes s 60(3)(c)	Yes s 63(1)(d)	Yes s 65(1)(a)(ii)
Disclosure Document to Shareholders	-	Yes pre-offer s 61(5), 62	Yes pre-offer s 63(6), 64	Yes post aquisition s 65(2)
Objection Procedure (Creditors)	-	-	-	-
Objection Procedure (Shareholders/ Company)	-	Yes Shareholder OR Company s 61(8)(a)	Yes Shareholder OR Company s 63(8)	-

Appendix B
AUSTRALIA

PUBLIC COMPANY BUY-BACKS

Conditions to be satisfied

Type of Buy-Back	AUTHORISATION IN ARTICLES (Note limited life - s 133DB)	AUDITED SOLVENCY DECLARATION	10/12 LIMIT	SHAREHOLDER APPROVAL	CREDITORS' OBJECTION PROCEDURE	EXPERT REPORT ("Fair & Reasonabl
BUY-BACK SCHEME (Proportional offer to all shareholders, like Part A takeover)	Yes s 133DA	Yes s 133MA	Yes s 133EA	Only if takeover - pending s 133GA	Yes s 133LA	-
ON-MARKET PURCHASE	Yes s 133DA	Yes s 133MB	Yes s 133EA	-	-	-
SELECTIVE BUY-BACK (Special deal with one or more shareholders)	Yes s 133DA	Yes s 133MB	Yes s 133EA	Yes - special 75/75 majority s 133JA	Yes s 133LA	Yes s 133KE
EMPLOYEE - SHARES PURCHASE	Yes s 133DA	Yes s 133MB	Yes, unless shareholders approve s 133HA	Only if 10/12 limit exceeded s 133HA	-	-
ODD - LOT PURCHASE	Yes s 133DA	Yes s 133MB	-	-	-	-

PROPRIETARY COMPANY BUY-BACKS

Conditions to be satisfied

Type of Buy-Back	AUTHORISATION IN ARTICLES	SOLVENCY DECLARATION	AUDITED SOLVENCY DECLARATION	SHAREHOLDER APPROVAL	CREDITORS' OBJECTION PROCEDURE
BUY-BACK SCHEME (Proportional offer to all shareholders, like Part A takeover)	Yes s 133DA	Yes s 133MA	If the buy-back exceeds the 10/12 limit s 133MA	Ordinary resolution required if: - the 10/12 limit is exceeded; or - a takeover is pending or remains open s 133GA	Yes s 133LA
SELECTIVE BUY-BACK	Yes s 133DA	Yes s 133MB	If the buy-back exceeds the 10/12 limit s 133MB	Special 75/75 majority if the 10/12 limit is exceeded s 133JB	Yes s 133LA
EMPLOYEE SHARE PURCHASES	Yes s 133DA	Yes s 133MB	If the buy-back exceeds the 10/12 limit s 133MB	Ordinary resolution required if the 10/12 limit is exceeded s 133HA	-

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