LEGAL ASPECTS OF FINANCING MANAGEMENT BUYOUTS AND PRIVATISATION

QUESTIONS AND ANSWERS

Question - Richard MacLean (Buddle Finlay, New Zealand):

I was most interested to hear John O'Sullivan say that in Australia directors who are appointed by minority shareholders cannot use information gained in their capacity as directors for the benefit of the shareholders appointing them. In New Zealand there is a great debate going on about this and views are divergent. The Securities Commission Chairman, Colin Patterson, in New Zealand says that people who do this should go to jail. Ron Brierley on the other hand says that he will use any information gained in this way for whatever purposes he thinks will benefit his own shareholders.

The question I ask John O'Sullivan is how has that activity been stopped in Australia? By the extension of the directors' duties to shareholders, legislative provision or perhaps stock exchange regulation?

Response - John O'Sullivan:

As David Saunders pointed out, it has not in fact stopped nominee directors passing on information to their appointors. Perhaps I could make clear what I think the legal position is.

Majority shareholders who have the right to appoint a director have no right greater than any other shareholder to corporate information. Certainly they have no right to have their nominee director give information to them for their benefit in circumstances where them having that information may be to the prejudice of other shareholders. I think that is the legal position.

David Saunders pointed out that as a practical matter it is widely ignored. Certainly, there is a problem in that majority shareholders have got all the corporate information. Therefore they can promote the forms of sales that they prefer, which may or may not include management buyouts.

Management, on the other hand, have no right whatsoever to use corporate information for their own benefit. For example, if managers decide that they would like to mount a management

buyout, they cannot take sensitive financial information along to an LBO specialist and say: "here are the figures, can we mount an MBO bid, and if so, what can we afford to pay?". So theoretically, managers are in the same legal position as major shareholders, but in practice, I suspect, commercial people, LBO specialists, will certainly tell you that they think managers are in an inferior position. Does that answer your question? I can be more specific. I think that the rules are fairly clear but the problem is that they are ignored.

Question - Norman O'Bryan (Minter Ellison, Melbourne):

On the same topic, I would like to ask Gar Emerson whether in Canada there are equivalent provisions in the corporations legislation as are in our Companies Code ss.228 and 229? Just for Gar's benefit - s.228 prevent officers of the company, which of course includes all employees as well as directors, from making use of any information or making use of positions to gain an advantage. Does the same legislation occur in Canada?

Response - Garfield Emerson:

Yes. Our legislation goes farther than that. It restricts not only directors, officers and employees from using confidential material information for their own benefit, but it also, under our securities legislation, includes anyone who is in a special relationship with the company. That will include any professional advisor to the company who obtains inside information as a result of his engagement with the company, any party who has a business relationship with the company and who thereby obtains inside information, not only legal and financial advisors as well.

In addition, the legislation also restrains tipees - namely, a person who acquires information from any of the foregoing in a situation where he knows that the foregoing person has such a relationship with the company. In other words, if you tip your gardener and he knows you are a director of a public company, he becomes subject to the same fiduciary obligations as the director himself.

Clearly, under Canadian law, corporate information is a corporate asset and it is not the question whether or not the use of that would injure a third party or a shareholder, the question really is that no one is entitled to benefit from it. To the extent that anyone does or attempts to benefit from it, it is a statutory offence, of course, but they are clearly subject to disgorgement at the institution of the corporation. If the corporation does not bring the action, the Securities Commissions have the authority in effect to bring a derivative law suit.

With respect to any third party who suffers a loss by dealing with someone in a special relationship who improperly uses inside information, the person so improperly using it is subject to a

double liability. First of all he is subject to damages to the corporation for the amount of the benefit, and secondly, he is subject to civil damages to the third party who lost as a result of the transaction.

These new insider trading rules, if you will, became effective in Ontario last June, and in a sense provide the Statutory Code in Canada for the equivalent of Rule 10B5 in the United States. I think it is fair to say that the Securities Commissions in Canada are the prime regulators of this kind of action and that it is being enforced very carefully. There is a whole new mood with respect to our Securities Commissions in terms of supervising and regulating this kind of activity.

With respect to virtually every takeover of a public company, within days after the announcement of the takeover, where there has been any appreciable move in the stock prior to the announcement, the Securities Commissions and the stock exchanges request full information from all people involved in the transaction, including lists and chronologies of those who participated, the time they participated, the extent of their participation, including of course professional advisors, financial advisors, accountants and lawyers. And then they simply trace all of the trading through the stock exchanges against all of the names of everyone involved. So it is quite a serious issue.

Question - Norman O'Bryan (Minter Ellison, Melbourne):

Can I just ask a follow up question to that? The reason for the question Gar, was that you had indicated, I thought, that the situation in Canada was such that it facilitated negotiations between the management and the directors of a company. But it would seem, from the extent of your legislation, that it is at least as difficult as it is in Australia to allow those negotiations to continue, having regard to the fact that it is virtually impossible for the management not to use information acquired by virtue of position, or the position itself, in the context of the negotiations.

Response - Garfield Emerson:

As I mentioned earlier, one of the "techniques" I guess you might call it, that has been developed, for the management of the corporation to conduct with the consent of the board of directors, a strategic review of the corporation with a view to considering all options available to the corporation to maximise shareholder values. As part of that program, often one of the options that will be present should management have an interest in it, will be whether or not a management buyout is likely or could produce values to shareholders that are greater than values that can be achieved in other ways.

Part of the process includes the company retaining financial advisors who prepare strategic reports on values including

whether or not a restructuring is appropriate, whether or not a sale of certain assets and distributions to shareholders are appropriate, what might be a possible range of values for third party bids, including possible values that management may pay for the company.

To the extent that management may have an appreciation of values of the company that are greater than third party views and are prepared to put a proposal to the board, then they may have the ability to continue discussions. At this stage there is nothing public. The fact is that management is carrying out what I think is quite properly its duties in terms of maximising shareholder values.

If the discussions proceed and come to nought, then there is no disclosure of the fact of those discussion. At that stage no one has taken advantage of inside information. Certain alternatives and options and proposals have been explored, certain discussions may have ensued, but no transaction would have resulted. If the board, as I mentioned, creates a special committee, the negotiations get more serious and the board will then retain its own financial advisors, its own independent legal advisors who will not be the lawyers for the company but separate outside counsel, and then they strike a deal on an arm's length basis with management for a proposal. At that time, the fact of the negotiations and the fact that an agreement has been reached will then be publicly disclosed.

Question - Norman O'Bryan (Minter Ellison, Melbourne):

If I can make a comment, and then ask Gar to follow that up in the Canadian context. One of the things that concerns me in Australia is that you can set up an independent committee, a special committee, to consider the best way of maximising shareholder value - you can get a merchant banker in. Let us assume you come up with a recommendation that a management buyout is the best method of maximising shareholder value. Management would generally include a couple of directors, they will have to go to banks and they will have to go to LBO specialists to raise some capital. To do that they will need corporate information.

Leave aside for the moment our s.128 of the Securities Code - the insider trading business. If they go to a bank or an LBO specialist in order to obtain funding for the bid, it seems to me as a matter of Australian law, that that is using corporate information which is an asset of shareholders, for their own benefit. I do not think they can be released from that duty by action of the board of directors. I think they can only be released from what would otherwise be a breach of their duty, by the shareholders. That is the Australian position.

Now that is easy where the vendor, where the MBO you are talking about is, as in most Australia cases, a sole shareholder vendor, because he just releases. What about a public company? What

about a listed company? How do you authorise the release of that information?

Response - Garfield Emerson:

We do not have the problem of shareholder authorisation in those matters. The general theory under Canadian corporate law is that the board of directors has the power, the authority, and indeed the duty, to manage the company, and there are only certain areas where shareholders' authorisation is required (e.g. to change the articles, to sell all or substantially all of the assets and things of that nature). In transactions of the nature that you are referring to, the board would authorise the use of confidential information pursuant to a negotiated form of confidentiality agreement pursuant to which the use of the information would be specifically limited for specific purposes. All people who receive that information would be subject to the same confidentiality agreement. The board would allow the use of the information under the terms of the confidentiality agreement, on the basic condition that all shareholders would benefit from any resulting transaction. The information would be one which would create an offer to all of the shareholders for their shares equally, pro rata, and on identical terms, and therefore in that sense the board is furthering the interests of the shareholders.

Comment - Stephen Franks:

John, on this issue you made a comment which I think was quite revealing in that, as I understand it, the Australia provisions were intended to be a codification of common law. And when you were explaining the position of directors, I think you said right at the end that they were using that corporate asset to the detriment of other shareholders. I suspect that you probably added that because it is common sense, but I do not think that is your law or the common law. Regal Hastings v. Gulliver and Boardman v. Phipps did not actually say that you could get away with using a corporate asset or using your position to your own advantage if it did not constitute a detriment to other shareholders.

That is quite a problem because, as I understand it, the SEC's economists and some of the recent discussion by the SEC suggests that the best guarantee for shareholders generally, that a takeover will not occur at a price below the underlying intrinsic value of the assets, is the prospect of a management buyout or a management financed or management initiated self share purchase. The argument goes, that they are the people who will at least know if the potential takeover offeror is getting too cheap a bargain, and therefore the outside shareholders should be given the protection of management in its own interests trying to top an offer from an outsider.

So it interests me that I think lay people and business people generally assume that the law will say that I cannot misuse this

information or this asset for my own advantage if it is going to cause detriment to other shareholders. But in fact, as I understand it, the law does not have that extra line, it just says I cannot use it.

Response - John O'Sullivan:

Well, when I was talking about codification of the common law, I was actually referring to s.129 rather than s.229. Yes, you are correct. I think as a matter of Australian law it is difficult to see where an action would be brought, or why, if there is no detriment to anybody. So I think you are right. You do not have to prove detriment to be caught by common law fiduciary duties.

If you can prove detriment though, I think you also fall into the penal provisions of s.229 of our Code, which talk about improper use of information. The word "improper" in s.229(4), I think it is, is difficult to define, but I think it must include circumstances where information is used for the benefit of employees or directors and to the detriment of others. Has anybody else got any views on this - Australians, New Zealanders? I would be interested to know can directors release people from these kinds of authorisations, need for authorisation, or is it just shareholders?

Comment - Rory Derham (Mallesons Stephen Jaques, Melbourne):

That conclusion may well be correct, but I think you said something about that the information is the information of the shareholders. I have got doubts about that. Shareholders have no interest in the assets of the company - the information is the company's assets as the Privy Council held in McCarra v. Northern Assurance.

Response - John O'Sullivan:

Loose use of language!

Comment - Paul Darvall (Auckland, New Zealand):

I would like to comment at some length on this whole question of the law in relation to management buyouts and the question of directors duties, but first just a couple of very brief comments on corporatisation and privatisation. I certainly re-emphasise everything Stephen Franks said, and particularly the rather ingenuous attitude of many quangoes when they hit the real world. Although lawyers obviously can give them certain assistance in the law of the jungle, nothing actually beats an extremely good chairman for the new organisation, who is versed in the ways of the world. And if you can do one single thing for a government department or government organisation that is going to be corporatised, it is to give it a superb chairman to negotiate with investment bankers, negotiate with the government, anything else - that is the single most important thing you can do.

On privatisation, just one simple comment, in that clearly the organisation will usually have funding facilities and even if these have not been formally guaranteed by the government, and even in cases where there is only a partial government ownership, the lenders, particularly the Japanese banks, take a very cautious attitude to the loss of government control. And this is one of the major issues that a buyer of even an already corporatised or even partially privatised organisation needs to take into account when assessing his purchase, because the mere fact that the government is a partial shareholder will usually be of considerable impetus to people in having made credit available to that company.

Now going on to the main topic which is the question of management buyouts, really it raises in a very succinct form, a lot of the major issues that are actually facing or accompanying commercial law reform in this area. And I think the discussion we have had tends to demonstrate, in my view, the marked superiority of Canadian law, certainly over Australian law, and questionably over New Zealand law.

There are three issues which no doubt many in the audience will come back to with differing views from my own. The essential issues that are raised - the first of public protection, which tends to come up in the formal takeover area. Second, there is the question of financial assistance (Australian s.129). And the third area is that of minority acquisition (the New Zealand s.208).

If you focus on what has happened in Australia, we have effectively taken our English based Companies Act and gone down what I would call a restrictive path. That is, the legislation has become more and more prolix, more and more detailed, with more and more rules saying what you can and cannot do, and the whole thing tends to be based, as Stephen Franks said, very much on the trustee concept - Boardman v. Phipps - and that basically if you are a trustee you just cannot deal with assets, no matter what.

And I would question whether, certainly in New Zealand, the law would be applied in quite that strict rigour. But that is the whole emphasis behind it. Now in Canada, by and large, and in the United States with their Model Business Code, if I read them correctly, they are what I would call "enabling legislation". In other words, by and large the directors are entitled to do what they believe is in the best interests of the company. They are not restrictive mechanical formulae at all, but if they are not in the best interests of the company, they can certainly be sued.

Now over the past six months, I for my sins, as Chairman of the New Zealand Law Society Committee on Company Law Reform, have been looking at this. Our recommendation at the end to the Law Commission is that probably New Zealand should make a major reverse with its policy and get away from the restrictive

approach and get on to the enabling approach, the sort of approach we have got in Canada. Because as has come up, the restrictive approach does cause huge practical problems. Of course, if you get away from the restrictive approach, maybe you get a lot of charlatans taking little old ladies, minority shareholders, to the cleaners, and it certainly requires more vigorous litigation of suspect case than certainly has been the case in New Zealand.

In summary, what I am saying is that the whole debate over this really is a debate which extends far beyond the particular cases we have been dealing with, to the whole basis of company law. Is it restrictive? Does it go to immense lengths trying to lay down mechanical formulae and what you can and cannot do or does it have the relative elegance of the Canadian law? And I am under no doubt, and certainly my colleagues in the New Zealand Law Society Committee are under no doubt, that we should go the Canadian way.

The second comment that I would talk on briefly, is the problem of the New Zealand s.208 - that is acquisitions of minorities. Again, I think that probably a fundamental rethink of the whole principles of when you can buy out minorities is required. From the discussion that has been held, it seems to me that more or less Australia, New Zealand and Canada are pretty much in the same sort of situation and there are no ideas coming up. Now if a conference like this does anything, it really should be in these areas, to formulate new ideas and say these are the problems we have got and what do we actually do about solving them.

One thing I have noted, that appears to have occurred a number of times in Australia and which has not been mentioned, is holding shareholder meetings of companies to change, for example, articles to allow expropriation of minority shares, and in one case, I believe, even to try and change ordinary shares into preference shares, which seems to me to be a little suspect. But this certainly has occurred in Australia and there has been some newspaper publicity about it. I personally have severe doubts as to whether it works but it appears to have.

The third area for comment is our s.62, your s.129 - apart from s.129(10) which certainly, if you can use it, appears to be a panacea for everything, I think the whole law on this subject needs to be rewritten and again the Canadian example is appropriate. Really what that says is, if I understand it correctly, that by and large there is not a prohibition on giving financial assistance, but that the directors have got to be damned sure it is in the company's interest and for the company's benefit. In particular, I do not really believe that the Australian law does get around the problems raised by Belmont Finance, and certainly in New Zealand we have got immense problems with whatever we do with Belmont Finance, which as I read it is that by and large no matter how arm's length your

transactions are, if they appear to assist the takeover in some way, you could be in real trouble. And this, certainly in New Zealand, creates a major problem for giving clean legal opinions in MBOs.

Well, in summary, I think that we do need a change in the law in Australia and New Zealand. I think far more emphasis on the Canadian approach is needed and this black letter restrictive law, I think, is hampering quite a number of commercial transactions to very little discernible public benefit.

Comment - John Cadell (Chairman):

Thanks Paul. I guess we should check with Gar Emerson that his view is not that Canada should adopt Australian company law!

Response - Garfield Emerson:

I did not have a chance, in terms of my discussion earlier, to talk about the financial assistance sections, but on page 19 of the summary that is in the folders, you will see there is reference to s.42 of the Canada Business Corporations Act which, effective in 1975, dramatically revised the corporate provisions in Canada, permitting Canadian corporations to provide financial assistance to others - including directors, shareholders and officers and others - in connection with acquiring shares of the company. This provision has subsequently been adopted by the other Provinces, so virtually all of the Canadian corporate law is now the same.

The test basically is that subject to the directors' fiduciary duties, all of the power, and the exercise of those powers of course being subject to that litmus test, the directors can provide financial assistance to parties with respect to acquiring shares or otherwise, provided that the realisable value of the assets remaining exceeds the aggregate of the liabilities and stated capital. And in effect that is a solvency test. So provided you meet that test that your realisable value exceeds, in effect, the claims against the company and that you can pay your debts as they become due, then the directors can provide financial assistance. Beyond that, a corporation can provide financial assistance even when it is insolvent in certain other circumstances, including where a subsidiary provides financial assistance to its wholly owned parent.

Now the recent jurisprudence in Canada has moved that one step further to allow, as part of a management buyout or any third party buyout, an agreement beforehand whereby the target company agrees to give security to the buyer effective after it becomes wholly owned. In other words, going into the transactions you can structure the financial assistance of the target to help the buyer get its lending in order to do the transaction to begin with.

Question - Gregory Burton (ANU Law School):

Two questions - one is to Gar Emerson. We have some confusion in our law on fiduciary duty about purpose, and given the comments of the Honourable Mick Young and several others, that you do not set up a review unless you know the result before you start, I was just wondering if you have had any experience with challenges on the grounds of the purpose behind one of the reviews - which I endorse as a very sensible approach to the management review. But if someone could show that the likely outcome was a recommendation in a management buyout, whether you have had any challenges on the grounds of substantial purpose leading to a breach of fiduciary duty action?

The other comment is to David Saunders. Where it is possible for the buyout specialist to take a small shareholder position in a company prior to or during the negotiations and investigation, I wonder if that helps with the information problem, and whether you have had any experience of that?

Response - Garfield Emerson:

I am not sure where the Canadian law is with respect to the purpose of the directors' action, if that is what your question is, if whether or not it picks up some of the UK cases about collateral purpose and improper purpose in exercise of their fiduciary obligations. I think the Canadian law in other areas is somewhat of a mixture between UK, but at the same time picking up more of the business purpose rules from the United States jurisprudence. And cases go both ways. I think that where you see a bad example it is clear and then they will follow the UK cases and that Privy Council case from New Zealand about not using corporate powers to effect control - i.e. you cannot issue shares to effect control.

We have a recent case in a takeover bid area, where the target company issued sufficient shares to effect control constituting 40 percent of the currently issued outstanding shares. The court cut that down and held that transaction to be void. In another case, Tech v. Afton Mines in the early 1970s, the directors issued shares in a takeover bid context, and it was upheld as being in the best interests of the company because the directors honestly believed that to issue shares to a certain party with whom they were in negotiations before the takeover bid commenced, was honestly, in their belief, in the best interests of the company.

A lot of these cases, I think, depend on the extent of the directors' action in response to what is perceived as a threat to the corporate survival of the company and its shareholders etc., and the extent of that action.

Now in the management buyout area though, I think that it really goes the other way in the sense that the board, in authorising

management to consider or make a proposal, is not excluding anyone else. As a matter of fact, if a third party comes along and makes a better bid, management loses. In my view, some of the problems come where the directors are acting in a conflict of interest situation, one way or another, or otherwise stopping the option, i.e. by entering into a transaction which gives someone a favourable down side if a third party comes along, i.e. being able to buy the Crown jewels or being able to buy valuable assets at a favourable price. Once the directors go beyond that kind of a transaction and lock it up and favour someone and prevent the shareholders from receiving independent third party bids, then that is when I think the directors get into trouble.

Response - David Saunders:

I would just like to pick up on the first part of the question, if I may. I think one of the problems with the concept of a strategic review, as it might work in Australia, is that I guess over the last five years or so, some of the independent expert reports which have been produced under NCSC guidelines, have lost a certain amount of their credibility, and we have now got to a stage where you are getting competing independent expert reports, depending on which side of the transaction you are. And in those circumstances I guess you have got to wonder exactly how independent the reports are. I think that would probably be a problem in the Australian context. I think that particular manoeuvre has lost its credibility.

I move on to the point about Crown jewels, which was raised, loading the odds in favour of the LBO specialist/management group in making a bid for a company. It is not impossible that the LBO specialist and management group might, in fact, say to the board of directors, the independent members thereof: "it is going to cost us a hell of a lot of money to put this deal together - we have got to negotiate with banks, we have got to pay establishment fees, we have got to pay the exorbitant lawyers' fees - and we are only prepared to do it if we have some kind of underpinning of our risk". And that is, I guess, one of the bases on which the kind of Crown jewels strategy developed in the US.

I turn now to the second part of the question - whether it makes any difference for the LBO specialist to have an equity position. First of all, as a practical matter it is very difficult for Byvest to do that the way we are constituted; second, as I understand it, (and I have to say thank you for all the free legal advice I am getting at the moment) even if I do have, or even if Byvest does have, an equity position, it is still corporate information, and I am therefore still not entitled to it. So we have never contemplated doing that to try and get better access to the information.

Now just as a kind of amusing aside, finally, this problem of access to information is such that at Byvest we actually found,

in one particular transaction, that I, who was a director of the company concerned, could not go back to Byvest and tell the supervisory board and my fellow directors and my shareholders whether we were making any money out of the investment, because I was bound by confidentiality agreements at the corporate level. We actually deal with that now by having articles of association specifically allowing us to make that kind of information available to our investors on a case by case basis. Otherwise we did find that we had a legal problem in meeting our reporting obligations as they are set out in Byvest's constituent documents. I hope that has answered the question.

Comment - John O'Sullivan:

I might just make one comment out of those I can. I suppose the first thing any bank, or merchant bank, which is approached by the management and asked to consider funding it, must say to them is: "establish your right to show us this information". I would think any bank that looked at any papers without having a very clear answer to that, is buying its way into a fight. Indeed, that applies to the LBO specialist as well as the bank.