CAPITAL MARKETS FUNDING - LEGAL DREAM OR NIGHTMARE? EQUITY LINKED INTERNATIONAL BOND ISSUES BY AUSTRALIAN CORPORATIONS

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The past eighteen months have seen a number of international bond issues by members of Australian based groups, convertible into, or otherwise linked with options to acquire, shares in the listed Australian parent of the group. This firm has been involved with, amongst others, issues by CSR Finance Limited and TNT Finance Limited.

The shape of international equity linked bond issues by Australian groups has been substantially determined by the inconsistent requirements of, on the one hand, market expectations in the Euro-markets and, on the other, Part III Division 3A (convertible notes) of the Australian Income Tax Assessment Act, 1936 (the "Tax Act"). Market practice in the Euro-markets requires that the unit price of shares acquired on exercise of an option remain constant, determined by reference to the capital structure of the issuing company as at the time of the issue of the option. The terms of issue of equity linked securities will provide, in effect, that any variation in the capital structure of the listed parent which has the effect of reducing the aggregate value of the shares to be acquired by an option holder on exercise of his option at the then current option price will result in either:

(a) more commonly, an adjustment downwards of the option price; or

(b) an adjustment upwards of the number of shares open to be acquired at the option price.

Whichever approach be adopted, there is a real likelihood that at some time in the life of an issue the unit price of shares open to be acquired on exercise of the options will fall, and thus there can be no certainty that section 82SA(1)(d)(xi) of the Tax Act will be satisfied. This is a requirement that, in order to ensure the deductibility of interest payments on convertible notes, the exercise price for the option embodied in a convertible note issued by an Australian resident must not be less than 90% of the market price for the relevant shares, determined in accordance with the Tax Act shortly before the actual issue of the convertible notes. The consequence is that issues (including all with which we have been involved) are customarily structured so as to ensure that the bonds do not amount to convertible notes for purposes of the Tax Act.

The Tax Act defines convertible notes in fairly broad terms, and includes the rather unhelpful provision (section 82L(2)) that where "... the combined effect or operation of two or more related instruments, whether issued at the same time or not, would have the effect or operation of a convertible note, those instruments shall, for purposes of this Division, be deemed to be together a convertible note". This has reduced considerably the structural options available, so that only three structures are currently in use for such issues. The fundamental principle which underlies all three structures is that the debt instrument ("debt bond"), on the basis of which funds are to be raised and interest paid, should be issued by a different corporate entity from that which issues the options: since the latter will be the listed parent, the borrowing vehicle will, therefore, be a subsidiary member of the group.

The three structures are:

(a) The debt bond, with coupons attached, is issued by an Australian resident subsidiary of the listed parent. Attached to the debt bond at the time of issue is an option, granted by the listed parent. Both the debt bond and the option are bearer instruments, and the option may, at any time after its issue, be detached from the debt bond and separately traded;

(b) An Australian resident subsidiary of the listed parent issues the debt bond, with coupons attached. Attached to it at the time of issue is a non-interest bearing bond ("conversion bond") issued by the listed parent, with an option to subscribe for a number of shares in the listed parent. The conversion bond is partly paid, say to $0.01, and has a face value equal to the maximum amount payable on exercise of the option. The face value of the conversion bond does not necessarily bear any relationship to the face value of the debt bond. The conversion bond may be detached from, and traded separately from, the debt bond. The option may only be exercised out of the proceeds of redemption of the conversion bond which must, under its terms, be paid up in full before it can be redeemed. Payment up and redemption of the conversion bond and exercise of the option may take place at any time; and

(c) A foreign resident subsidiary of the listed parent issues debt bonds, with coupons, and with a conversion bond issued by the listed parent attached. The conversion bond is partly paid, has the same face value as the debt bond, and embodies an option to acquire shares in the listed parent. The option may only be exercised out of the proceeds of redemption of the conversion bond, and the conversion bond may only be redeemed once fully paid. The conversion bond may be paid up only out of the proceeds of redemption of the debt bond, which may only be redeemed at certain specific times. In view of the intimate connection between all of the instruments in this case, the conversion bonds may not be detached from or traded separately from the debt bonds. This third structure is rather closer in its effect to the traditional convertible note than the other two.

The type (a) structure was used in the TNT issue, the type (b) structure in the CSR issue and the type (c) structure in the Elders IXL issue in 1984. There is no reason why further variations on these structures should not be suitable for different issues, depending on the relevant commercial considerations: notably, the length of the options, the desirability of having separately tradeable options and the likelihood of swapping the debt proceeds. Swaps will generally be easier to arrange if the option component is separated from the debt bond.

Several detailed comments should be made in relation to the structures:

A. Tax:

(a) Deductibility of interest: The Australian Taxation Office ("ATO") appears to accept that in none of the three structures are the borrowing costs attributable to a convertible note which does not conform to the requirements of Part III Division 3A of the Tax Act (a "non-conforming note"). In the case of structures (a) and (b), the ATO has expressed the opinion, on the usual non-binding basis, that interest payable on the debt bond will be deductible. The argument, in the case of structures (a) and (b), is that because the option component (whether a simple option or a partly paid conversion bond) is separable from the debt bond, and can be separately traded, the debt bond and the option are not properly viewed as related instruments for purposes of section 82L(2) and thus cannot be treated as a non-conforming note. The only sense in which they are related is that they happen to be issued at the same time and as part of a single transaction. The ATO accepts that, in structure (a), the options themselves do not amount to notes for purposes of the Tax Act. Although the conversion bonds in structures (b) and (c) may well themselves amount to convertible notes, neither of them bears interest and the question whether they are non-conforming notes has no practical importance. Turning more closely to structure (c), it could, in the absence of authority (see below), be argued that the debt bond and the conversion bond, are related within the sense of section 82L(2), since they may not be separated. However, since the debt bond is issued by a non-resident of Australia the deductibility in Australia of interest paid on it is not relevant. (Repatriation of funds raised by an issue of the kind described in structure (c) does give further opportunity to the ATO to investigate the transaction from a tax point of view, but to date in our experience the ATO has not expressed any adverse views in relation to structure (c)). In any case, the decision in <u>Network Finance Limited</u> v. <u>Federal Commissioner of Taxation</u> (76 ATC 4336) supports the proposition that even though the conversion bonds in structures (b) and (c) may themselves amount to convertible notes, the combination of debt bonds and conversion bonds does not in either case amount to a convertible note for purposes of Division 3A of Part III of the Tax Act.

(b) <u>Withholding Tax</u>: Interest payable on debt bonds issued by an Australian resident as part of an equity linked issue (structures (a) and (b)) is subject to Australian interest withholding tax, unless the conditions of section 128F of the Tax Act are satisfied. Similarly, if the funds raised under structure (c) are lent by the offshore borrowing subsidiary to its Australian parent, then interest payable by the parent on the loan to it will be subject to Australian interest withholding tax. In order to obtain an exemption, the conditions of section 128F(6) of the Tax Act must be satisfied in this case.

(c) <u>Foreign tax considerations</u>: The first is U.S. tax, in the form of the Taxation Equity and Fiscal Responsibility Act ("TEFRA"). This restricts dealings in bearer bonds by U.S. persons, and imposes certain potential liabilities on issuers of bearer bonds. Whilst the lead manager and its London or New York lawyers will make provision in the issue documents for TEFRA so far as it affects bond issues generally, the situation of the particular issuer may make it advisable to obtain further advice in the U.S., especially if the issuer's group has assets or operations there.

The second is applicable only to structure (c), where (as is often the case) the issuer of the debt bond is incorporated in the Netherlands Antilles. If the issuer does not make a taxable profit in the Netherlands Antilles by on-lending the issue proceeds, it will be required to pay Netherlands Antilles tax on the basis of a notional minimum profit on the on-lending. Details should be checked with Dutch tax advisers.

There is clearly some potential conflict between the Netherlands Antilles requirements and section 128F(6) of the Tax Act. This sub-section imposes a condition for the issue of a withholding tax exemption certificate that the offshore finance subsidiary which issues the debt bonds makes no profit in on-lending the proceeds of the issue into Australia. So far as we are aware, Australian issuers have viewed the Netherlands Antilles tax as the lesser of two evils.

B. Duration of the Option:

The Companies Code provides that an option to take up shares in a company which is exercisable more than five years after it is granted is void: section 132(1). There is one exception, which applies in the case where "... the holders of debentures of a company have an option to take up shares in the company by way of redemption of the debentures": section 132(2). The form of option contained in structure (a) is one which will be void if exercisable more than five years after issue. It follows, therefore, that if the commercial dictates of the transaction require options having a longer life, structure (a) will be unsuitable. In this case,the conversion bond technique used in structures (b) and (c) should be adopted. Broadly, this is that the conversion bond will be paid up in full before and as a condition precedent to exercise of the relevant option, on terms which require that the conversion bond be redeemed and the proceeds of redemption used in paying the exercise price for the option. In this way, the option is one "to take up shares in a company by way of redemption of ... debentures", and thus within the exemption contained in section 132(2).

C. Registration Requirements:

Section 131 of the Code requires that companies keep a register of share options granted by them and section 147 of the Code requires that they keep a register of the holders of debentures issued by them. In each of structures (a), (b) and (c) the debt bond and the option (in case of structure (a)) and the conversion bonds (in the case of structures (b) and (c)) are bearer instruments, thus making it impossible to comply on a continuing basis with sections 131 and 147. We take the view that it is sufficient compliance with these sections if the issuing company opens registers of option holders and debenture holders (as appropriate) and enters into the relevant register the prescribed particulars of the first holders of the options or the debentures. In practice this is likely to be the trustee of manager who holds the temporary global debt bond and the temporary global option or conversion bond. Since, as a practical matter, companies which issue obligations in bearer form are unable to keep track of the holders from time to time of those instruments, no further information can or need be included in the relevant registers, once the definitive bonds, options and conversion bonds have been delivered. The subscription agreement should oblige the lead managers to provide the issuer with information sufficient to permit compliance with sections 147 and 131 in relation to the initial issue.

D. Stamp Duty:

Our view is that if the bonds, options and conversion bonds are executed (either manually or in facsimile), authenticated and issued outside Australia, and do not require on their face that any act, matter or thing be done in an Australian State or Territory, they should not be dutiable under the stamp duty laws of any Australian State or Territory. This is in accordance with the normal position for Eurobonds. These stamp duty precautions do mean that agents outside Australia must be appointed by the listed parent to deal with conversion bonds, the exercise of options, the issue of shares consequent upon such exercise and (if appropriate) the exchange of registered for bearer securities. As a practical matter this is probably not particularly onerous, since market practice will in any event demand that such facilities be available in a number of cities conveniently situated for likely bond holders - e.g. in the case of bonds issued on the European market, Brussels, Luxembourg and Basle. If debt bonds, options or conversion bonds are issued (or exchangeable for instruments) in registered form, the stamp duty implications of transfers of registered instruments will have to be considered.

E. Anti-dilution Provisions:

These were referred to briefly above. They are in fairly standard form throughout the Euro-markets, and provide that the exercise price of the relevant options or, more usually, the number of shares to be acquired on exercise of the options, will be adjusted on the occurrence of any of the following:

(i) alternation of the normal value of ordinary shares as a result of consolidation or subdivision;

(ii) the issue of ordinary shares at less than current market price;

(iii) the issue of securities convertible into ordinary shares at less than market price;

(iv) The issue of ordinary shares consequent upon a capitalisation of profits or reserves;

(v) any capital distribution to ordinary shareholders;

(vi) the issue of ordinary shares to holders of ordinary shares by way of rights or the grant to holders of ordinary shares of options or rights to subscribe or purchase ordinary shares, in each case at less than the current market price; and

(vii) the issue of securities (other than ordinary shares) to the holders of ordinary shares by way of rights or the grant to holders of ordinary shares of options or rights to subscribe or purchase any securities (other than ordinary shares) by way of rights.

Provision is normally made only for adjustment <u>downwards</u> of the unit option price. The anti-dilution provisions should state that the exercise price per share must not fall below the nominal amount of the share: otherwise, an issue of shares at a discount could result. Care should be taken in two other areas:

(a) to deal in the anti dilution provisions with shares issued under employee share schemes and under dividend reinvestment plans; and

(b) to ensure that the issuer's obligations on exercise of the options do not breach section 129 of the Code.

F. Australian Offering Restrictions:

In our view, if the initial distribution and sale of equity linked bonds is made exclusively:

(a) outside Australia; and

(b) to non-residents of Australia (which may include foreign branches of Australian companies or partnerships),

then no offer or invitation will thus be made to the public, for purposes of the Companies Code prospectus requirements. The basis for this view is that some geographical limitation must, as a matter of construction, be placed on the wide expression "to the public"; the obvious limitation, both in policy and in practical terms, is to the Australian public.

Since the most informed market for options in Australian listed companies is in Australia, the likelihood that equity linked instruments issued by Australian companies will eventually be sold back into Australia is greater than for straight debt bonds. From the issuer's point of view, this raises a major consideration in the form of section 104 of the Code. This provides that where a corporation issues shares or debentures "with a view to all or any of them being offered for sale to the public, any document by which the offer for sale to the public is made shall ... be deemed to be a prospectus issued by the corporation ...". Under section 104(2) an allotment or issue of marketable securities is deemed, until the contrary is proved, to be made with a view to the instruments being offered for sale to the public if it is shown that:

(a) any of the instruments was offered for sale to the public within six months after its first issue; or

(b) the instruments are in fact offered to the public at a time at which they are partly paid.

At a practical level, I understand from those who deal in the markets that there is probably little risk of the instruments' being offered on the secondary market in Australia by means of a written instrument, and thus no "deemed prospectus" under section 104 is likely to come into existence. If, however, such a document were ever created, the conversion bonds provided for in structures (b) and (c) would clearly be caught by section 104(2)(b), since they are partly paid. It is, practically speaking, impossible for the issuer to prevent on-selling of the equity linked instruments to Australian investors. It follows that, at best, it can try to establish a set of offering restrictions designed to limit offers of the instruments to the Australian public on the secondary market in Australia. These could be along the following lines:

(a) an absolute restriction on on-selling the equity linked instruments by means of any offering document issued to the public in Australia;

(b) an absolute restriction on offers of the instruments to the public in Australia; and

(c) a restriction on sales of the instruments into Australia for a period of six months after first issue.

Clearly, there remains a theoretical risk for the issuer. This, however, has proved one which, given the commercial benefits of equity linked issues, Australian issuers have to date taken quite willingly.

G. Companies Code - section 129:

We do not believe that any breach of section 129 of the Code (prohibition against a company giving financial assistance for the purchase of its own shares) will be occasioned simply by the making of an issue along the lines of structures (a), (b) or (c) above. The actual terms of exercise of the options, and any ancillary arrangements (e.g. interest or currency swaps), should however be considered in the light of section 129;

H. Companies Code - section 115:

This section prohibits the issue of share warrants by Australian companies. The conversion bonds or options provided for in structures (a) and (b) are often referred to in the Euromarkets as "share warrants". In our view, however, they are not share warrants within the meaning of the Code, but rather options. As such, their issue by Australian companies does not infringe the Code. In order to avoid confusion, it is best not to use the expression "share warrants" if at all possible.

The stock exchange listing requirements are also relevant. The principal listing requirement to be complied with is the "10% rule" contained in section 3E(6).

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