LEGAL ASPECTS OF FINANCING MANAGEMENT BUYOUTS AND PRIVATISATION

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INTRODUCTION: SPECIAL FEATURES AFFECTING FINANCING STRUCTURE OF MANAGEMENT BUYOUTS

(a) Division of Interests

Management buyouts are usually highly geared - financial covenants and existence of strong management control would be fundamental to lenders. A not unusual pattern in the US is 10 percent equity, 60 percent bank (senior) lender, 30 percent subordinated (mezzanine) lender.

(b) Competing Interests

I will not deal with directors' duties and issues of conflicts of interest arising in relation to a decision by managers to sell a business to (some of) its managers. It is worth noting that tensions also arise in the financing, examples of which are as follows:

(i) Management and financial investors (i.e. non-management) will generally want dividend payout ratios as high as possible (to service their own borrowings). Bank lenders and mezzanine lenders (if any) will want low dividend payouts.

(ii) Senior lenders and mezzanine lenders will need to negotiate the extent to which payments of principal, and more particularly, interest are subordinated or suspended in certain events. This has become an art form in the US.

(iii) Vendor finance is often supplied. Vendors will often want first ranking security. Bank lenders will also want first ranking security.

Please note that I intend dealing with management buyouts rather than privatisation. Also, I do not intend dealing with the effect on lenders of management's conflict of interests.

STRUCTURE OF PURCHASE: ASSET PURCHASE OR SHARE PURCHASE?

This will have a significant effect on security structures available to lenders. If an asset deal is chosen, the security structure is fairly straightforward. The lender would get security over the assets purchased. Where a share purchase is utilised, s.129 problems arise in relation to security for the lender over the assets of the business purchased.

I intend to deal with both types of structures. In dealing with asset purchases I will cover some of the traditional issues relevant in any MBO. In dealing with share purchases I will focus particularly on s.129 issues as I think these raise the most difficult problems.

ASSET PURCHASE

Assume an MBO is accomplished by a new company, Newco, which has been established to purchase the assets of a business. In such a case, traditional types of lending arrangements, e.g. cash advance/bill facility, would be used with Newco as borrower. The security supporting the borrowing is likely to be a straightforward mortgage or charge given by Newco over the assets acquired.

The financing and security structure is therefore typical of any acquisition financing. What does differ from most acquisition financings is the degree of control and monitoring a lender will require in view of Newco's high gearing.

Lenders in an MBO context will often require fairly strict financial ratios and impose stringent monitoring requirements.

The financial covenants required vary depending on the nature of the business acquired. Typical covenants may include:

(i) gearing - expressed as a maximum ratio of external debt to shareholders' funds;

(ii) interest cover - the ratio of earnings or cash flow to interest;

(iii) working capital ratios covering the ratio of current assets to current liabilities.

Dividend payout ratios are generally also restricted. Often senior and subordinated lenders will attempt to preclude payment of dividends until all, or a specified part, of the acquisition debt has been paid off. This covenant is often particularly hotly debated between lenders and borrowers (and sometimes, where mezzanine lenders have an "equity kicker", between senior and subordinated lenders). Both management and financial participants in an MBO will want dividend ratios as high as possible to support their own debt incurred to finance their acquisition.

Often bank lenders will want to exercise some supervision over management and management policies. They may wish to have some input into the contents of the shareholder's agreement. They will often seek to ensure that management participants in an MBO have invested sums which are substantial for those participants - "hurt money". Often they will also wish to see management participants locked in (i.e. unable to transfer their shares) for a certain period or until all the acquisition debt is paid off.

Very occasionally a bank may consider asking for the right to appoint a director to Newco. I am not sure that this is a very good idea because:

* Nominee directors (contrary to the assumption often made by appointors) have no general right to pass information to their appointor (see Bennetts v. Board of Fire Commissioners of NSW (1967) 87 WN 307 which indicates that any latitude in the application of directors' fiduciary duties to nominee directors will not apply to the communication by a nominee director of confidential information of the company. It should however be noted that the case involved a statutory corporation and may be distinguishable on that basis).

* Directors of course have onerous duties to members of the company. In addition, it now appears to be settled that in certain circumstances directors will have a duty to all creditors of the company (not merely the secured creditor who appointed them). See the High Court decision in Walker v. Wimborne (1976) 137 CLR 1, and the House of Lords decision in Winkworth v. Edward Baron Development Co. [1987] 1 All ER 114. Indeed the Winkworth decision indicates that directors will owe a duty to both actual (present) creditors and to future creditors. The duty was described in Winkworth as "a duty to the company and to creditors to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors". It should be noted that the continued solvency of the company concerned in the Winkworth decision was already in some doubt when the directors acted in disregard of their duties.

* In Berlei Hestia v. Fernyhough [1980] 2 NZLR 150, Mahon J. suggested that by appropriately drafting the Memorandum and Articles, usual directors' duties may be modified. (However, no modification in the Articles can reduce the standard of care and honesty set up by s.229 of the Companies Code).

SHARE PURCHASE: THE DRIVING FORCES BEHIND SECTION 129(10) RESOLUTIONS

The legal position where shares are purchased is much more complicated because of s.129 of the Companies Code.

In broad terms, s.129 prohibits financial assistance being given by a company for the purpose of or in connection with the acquisition of shares in the company or its parent, unless the authorisation procedure in s.129(10) is complied with.

(a) Security Driven

A lender will not usually be happy simply with obtaining security over the shares in Newco. This would not give the lender a security interest in the assets of the company ("the Target") whose shares are being purchased by Newco. Accordingly, lenders often require that a s.129(10) resolution be passed to enable the Target to give security over its assets to the lenders to Newco. Accordingly, the first common reason for use of the s.129(10) procedure is the need to give lenders better security.

(b) Tax Driven

The second main reason for use of the s.129(10) procedure in MBOs stems from the fact that interest on Newco's acquisition debt will often be set off, for tax purposes, against dividends to Newco from the Target, thereby wasting the benefit of dividend rebates. Prior to the 1988 income year, interest incurred in buying shares and deriving dividend income had to be set off against those dividends in order to determine the net dividends in respect of which the dividend rebate applied. For the 1988 and future income years, interest on monies borrowed to acquire dividend earning shares can be set off against other (non dividend) income so that the gross dividend may, if Newco has sufficient non dividend income, be fully rebateable and the full benefit of the interest deduction is obtained by setting off the interest against fully taxable trading income.

However, the new concession does not solve the problem in an MBO context since Newco generally only has dividend income.

Accordingly, it is common for one (or both) of two steps to be taken to ensure that interest deductions are not written-off against otherwise rebateable dividend income.

[Note that the tax problem may in some circumstances be resolved if the financing takes the form of the issue of redeemable preference shares. Where the Target has the capacity to pay franked dividends, preference share financing for MBOs may be more commonly used in the future].

The two steps are:

(i) Where the Target has, or by revaluation of assets can acquire, profits which can be distributed to Newco immediately on completion of the acquisition, the maximum possible dividend to Newco is paid on the date of acquisition or as soon as possible thereafter to reduce the acquisition debt. This will often reduce available working capital of the Target but if the Target subsequently borrows to finance working capital, interest is clearly deductible.

(ii) To ensure Newco has trading (i.e. non dividend) income against which interest expense can be deducted, trading operations of the Target may be transferred to Newco.

Both (i) and (ii) may cause problems under s.129.

(i) Dividends

As far as dividends are concerned, s.129(8)(a) provides that s.129(1) does not prohibit the payment of a dividend by a company in good faith in the ordinary course of commercial dealing. The words "in good faith" and "in the ordinary course of commercial dealing" appear to suggest that some payments of dividends would offend s.129(1). It was at least arguable, prior to s.129(8)(a) being enacted, that the payment of a dividend could not constitute financial assistance (in the absence of some exceptional circumstances) since the payment of dividends, at least where those dividends are supported by available profits, is the very purpose for which a company is established and therefore must presumably always be a proper function of the company. In the New Zealand decision of Wellington Publishing Co. Limited v. The Companies Act [1973] NZLR 133, the offeror in a takeover situation proposed to cause the Target to declare a dividend sufficient to pay out all of the acquisition debt once the takeover had been declared unconditional. The Target's revenue reserves were sufficient to meet the proposed dividend. Existing creditors of the Target were protected by a substantial excess of assets over liabilities. All of the shareholders had accepted the takeover offer. The court upheld the dividend.

The principles emerging from the Wellington Publishing decision may be summarised as follows:

(a) in considering whether a transaction (say, the payment of a dividend) constitutes prohibited financial assistance, a court will have regard to the substance rather than the form of the transaction;

(b) it may be that the payment by a company of a dividend to its controller will constitute prohibited financial assistance "in appropriate circumstances".

The decision throws no light, upon the question of what circumstances will be "appropriate". The inference which can be drawn from the decision is that if the company is in a sound financial position such that the declaration of a dividend will not jeopardise its solvency or long term prospects, the dividend may be permissible in terms of s.129.

In another New Zealand decision, Colman v. Myers [1977] 2 NZLR 225, a dividend was upheld although it was to be paid from the proceeds of liquidation of the target's major assets. The court in that case was influenced by the fact that the liquidation of those assets was part of a general change in direction of the company's business which had been under contemplation for some time.

The qualification expressed in the Wellington Publishing decision as to the possibility of an infringement of s.239 by the declaration of a dividend is borne out by the qualifications in s.129(8)(a) as to "good faith" and "the ordinary course of commercial dealing".

The NCSC in Release No. 400 makes the following comment:

> "In a recent case a company declared a dividend in connection with a takeover bid made of its shares equivalent to around half of the offer consideration. While in that particular case the dividend did not constitute financial assistance, the sudden emptying of the company's cash box through an extraordinary dividend for the purpose of putting its recipients in funds to refinance the company's takeover could be sufficient to remove it from the terms of the paragraph."

The NCSC's comment suggests that s.129(8)(a) could operate more restrictively than the general law limitations, which, in Wellington Publishing, permitted the payment of an extraordinary dividend which enabled the offeror to refinance.

In view of the uncertain operation of the qualifications on the power to declare dividends in this context, it is submitted that it would be prudent always to have dividend payments approved by s.129(10) resolutions.

Assuming the dividend has been appropriately blessed by s.129(10) resolution, directors will often try to make the dividend as large as possible. This is often done by revaluing assets and declaring a dividend out of the ensuing revaluation reserve. It would appear from Dimbula Valley (Ceylon) T Co. Ltd. v. Laurie [1961] Ch 353 that the case dividend may be paid on the basis of an unrealised capital profit provided that:

* the Articles of Association permit the declaration of a dividend in these circumstances;

* the revaluation which generated the unrealised capital profit was made in good faith by a competent valuer;

* the asset revalued is not liable to short term fluctuations in value.

In Blackburn v. Industrial Equity Limited [1976] ACLC 40-267, Needham J. approved the Dimbula Valley decision but left open the question whether a distribution of profit would be permissible where it arose from a selective or incomplete revaluation of the company's assets.

(ii) Transfer of Assets/Operations

The decision of the English Court of Appeal in Belmont Finance Corporation v. Williams Furniture Ltd and Ors (No. 2) [1980] 1 All ER 393 is authority for the proposition that a prohibition in terms of s.129 will apply where a company, without regard to its own commercial interests, buys something from a third party for the sole purpose of putting the third party in funds to acquire shares in the company, notwithstanding that the price paid to the company was a fair price.

The reasoning would, in my view, apply equally to a transfer of business assets/operations by the Target to Newco to assist Newco to pay off its acquisition debt in a tax effective manner. That is to say, if there is no commercial rationale for the transfer from the point of view of the Target, the transfer will offend the prohibition in s.129 notwithstanding that Newco pays Target the fair market value for the assets/operations. It is worth noting that a transfer in these circumstances may also involve a breach of fiduciary duties on the part of the directors of the Target.

SECTION 129: OTHER ISSUES

Examination of a recent example of the s.129 problems that may arise, namely that occurring in the acquisition by Tryart Pty. Limited of Fairfax, is instructive. I hasten to add that I know no more about the transaction than appeared in the newspapers and so if people present in the audience were involved in the transaction and can correct me on some of the facts of the situation I would be happy to have them speak up.

ANZ lent to Tryart to enable Tryart to purchase Fairfax. ANZ apparently stipulated that upon Tryart acquiring control of Fairfax, Tryart would cause Fairfax to pass resolutions under s.129(10) to enable Fairfax to give security to ANZ over Fairfax assets to secure the loans made by ANZ to Tryart for the acquisition.

I understand that the s.129(10) resolutions were duly passed and advertised. Shortly before the 21 day period for creditors to object to the resolution passed, a number of creditors of Fairfax, including, I understand, Westpac and the National Australia Bank ("NAB"), discovered that the effect of the resolution would be to give ANZ a security interest over the assets of Fairfax to secure debt owed to the ANZ. Westpac and NAB had apparently financed Fairfax's operations for a number of years on an unsecured basis and each had, I understand, some $150 million in debt to Fairfax outstanding. Westpac and NAB and, I understand, some other bank creditors of Fairfax objected (not unnaturally) to the resolution and sought relief from the court under s.129(12).

As I understand it, the matter did not finally reach the court as a compromise was reached whereby Citibank paid out the various bank lenders to Fairfax and reached an arrangement with ANZ for a sharing of security over the assets of Fairfax. As a result, no order was required to be made under s.129(13).

One issue raised is the effectiveness of the advertising procedure required by s.129(10). Section 129(10)(h) requires an advertisement "setting out the terms of the resolution" to be published in a daily newspaper circulating in each state and territory in which the company giving the financial assistance carries on business. It is at least strongly arguable that the resolution does not need to give full particulars of the financial assistance to be given. The relevant Notice of Meeting must contain full particulars of the assistance to be given and the effect that the giving of the assistance will have on the financial position of the company, but, arguably, the resolution itself need only say something like "resolved that the company give financial assistance particulars of which are set out in the notice".

If this view is correct, in order for creditors of the company to understand the assistance to be given, they must read the Notice of Meeting. True it is that the Notice of Meeting is required to be lodged at the Corporate Affairs Commission (s.129(10)(e)) and the Notice is therefore available for public perusal. However, this ignores the simple mechanical problem that the various state CACs are often a number of weeks out of date with filing and it is quite conceivable that the Notice is not in fact available for public perusal prior to the expiry of the period in which by virtue of s.129(10), objections to the financial assistance may be made to the Supreme Court.

As a matter of principle, if the advertising procedure is to adequately protect creditors, the advertisement (not the Notice of Meeting) should give enough detail to ward creditors.

The question of creditor protection was clearly determinative in the recent decision of Re U Drive Pty Limited (1987) 5 ACLC 116.

That case involved an application to the Supreme Court under s.129(11) for an order that there had been substantial compliance with s.129(10) notwithstanding that there had been a failure to comply with s.129(10) in the following respects:

(a) the notice of meeting had not been accompanied by a directors' statement;

(b) the Corporate Affairs Commission had not been notified the day after the notices were despatched; and

(c) in the advertisement, the assistance was said to be $54,000 instead of $540,000 due to a typographical error.

The applicant company was a closely held company with no creditors. The financial assistance was to take the form of a security over the company's assets in favour of the purchaser of shares in the company.

One might be forgiven for considering that the case involved a significant non-compliance with s.129(10), in particular in relation to the price referred to in the advertisement and in relation to the failure to provide a statement of the directors' reasons and particulars of the proposed financial assistance.

It is submitted that the case would have been differently decided had there been creditors who could have been misled by the advertisement. The case is useful in that it sets out a test for a court in determining future applications under s.129(11) namely, whether the shareholders, debenture holders, creditors and the Corporate Affairs Commission have received sufficient material of almost exact equivalent to that which they should have received under s.129(10) (had it been complied with) to enable them to make an election as to whether or not to apply to the court opposing the assistance. The court expressed support as a general principle for a strict interpretation of s.129(10) notwithstanding its finding in that particular case. With regard to the question of whether the resolution has been sufficiently disclosed in the advertisement, I suggest that disclosure "in substance" and that latitude in relation to, say, the date upon which the Corporate Affairs Commission received its notice may not be matched by latitude as to the accuracy or sufficiency of information conveyed to creditors.

It is true that s.129(10)(f) requires that a copy of the Notice of Meeting and the Directors' Statement must be given to trustees for debenture holders or, if there is no trustee for debenture holders, to debenture holders themselves.

However, as you know, considerable ingenuity has been devoted to ensuring that financing agreements and all monies charges which support them are not "debentures" in order to avoid stamp duty. Accordingly, facility agreements and all monies charges are often executed before any money is advanced and are structured so that they do not "evidence or acknowledge indebtedness of an incorporation" as required by the key part of the statutory definition of "debenture" in s.5 of the Companies Code.

As far as I am aware however, there have been no reported cases setting out the principles on which the court will exercise its powers under s.129(13) and this will often be a difficult matter to judge.

LENDER PROTECTION

To what extent should lenders simply rely on s.130(6) certificates? Lenders often require the payment of upfront dividends to reduce the acquisition debt. In that case, are they at risk if they simply rely on s.130(6) certificates?

Although a certificate obtained in accordance with s.130(6) will prevent the financially assisting transaction from being invalidated, if the lender (or any employee or agent of the lender) was aware, prior to entry into the transaction, that s.129(10) had not been complied with, the transaction will be set aside on the application of the company or any person, e.g. an unsecured creditor of the company, who has suffered or is likely to suffer loss as a result of the transaction.

The conclusion therefore should be that the lender's interest in ensuring that s.129(10) is duly complied with is paramount and may in some (admittedly exceptional) circumstances (e.g. where the lender is on notice of possible breaches of s.129 not adequately authorised under s.129(10)) require further inquiry, notwithstanding that a s.130(6) certificate is obtained.